COMMODITY FUTURES MODERNIZATION ACT

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
GENERAL FARM COMMODITIES
AND RISK MANAGEMENT

OF THE

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HOUSE OF REPRESENTATIVES

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COMMODITY FUTURES MODERNIZATION ACT

THURSDAY, JUNE 5, 2003

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GENERAL FARM COMMODITIES
AND RISK MANAGEMENT
COMMITTEE ON AGRICULTURE,
Washington, DC.

The subcommittee met, pursuant to call, at 10:01 a.m., in room 1300 of the Longworth House Office Building, Hon. Jerry Moran (chairman of the subcommittee) presiding.

Present: Representatives Smith, Pickering, Burns, Musgrave, Peterson, Alexander, Dooley, Pomeroy, Boswell, Etheridge, and Larsen.

Staff present: Jon Hixson, subcommittee staff director; Dave Ebersole, senior professional staff; Callista Gingrich, clerk, Kellie Rogers, and John Riley.

OPENING STATEMENT OF HON. JERRY MORAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF KANSAS

Mr. MORAN. Good morning. Our subcommittee will come to order, and we are here today to review the Commodities Futures Modernization Act.

I am delighted to have our witness today, Mr. Newsome, the Chairman of the Commodity Futures Trading Commission, with us. Just a couple of opening thoughts and then we will turn to our witness.

The futures industry plays an important role in the U.S. economy. Today, U.S. futures markets trade over 790 million contracts annually, and it is an industry that has changed a great deal in the past few years.

Technological changes have allowed the futures industry and options market to grow and evolve into an around-the-clock global industry. Legislative changes have allowed new products, such as single stock futures, to be introduced, given solid legal footing to existing products, and reflected the regulatory requirements of internationally competitive markets for risk management products. In the 3 years since the passage of CFMA, futures markets have grown and developed, as well as faced difficulties and challenges.

Today, the subcommittee begins a review of the futures industry, starting with the principal regulatory agency, the Commodity Futures Trading Commission. For an industry that has been heralded by the Federal Reserve Board Chairman, Alan Greenspan, as promoting flexible, resilient, and efficient financial systems, and criticized by Warren Buffett as a threat to the financial system, I look forward to hearing from Chairman Newsome to determine which of these financial icons we should believe. I welcome Mr. Newsome to the committee.

Mr. Peterson.

OPENING STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MINNESOTA

Mr. PETERSON. Thank you, Mr. Chairman, and thank you for holding this hearing. It is certainly timely for us to examine the results of the Commodity Futures Modernization Act, which has been law for about 2½ years. And I want to join you in welcoming Mr. Newsome, who has certainly distinguished himself first as a commissioner, and now as chairman of the CFTC. Though it doesn't get an awful lot of notice, the Commission serves a very important function as the regulator of U.S. derivatives markets, and Mr. Newsome has received wide acclaim for his leadership.

Mr. Chairman, even in the short time since CFMA's passage, significant events and great changes have occurred with respect to the derivatives market. As Chairman Newsome points out in his testimony, both the Commission itself and the derivatives industry have evolved in many ways. I look forward to Mr. Newsome's testimony today, as well as the testimony we will get from the industry representatives at our subsequent meeting on June 19. Thank you.

Mr. MORAN. Mr. Peterson, thank you very much.

Other statements for the record will be accepted at this time.

[The prepared statement of Mr. Smith follows:]

PREPARED STATEMENT OF HON. NICK SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Thank you Mr. Chairman for holding this informative hearing on the Commodity Futures Trading Commission. For many years the futures industry has been vital to the agricultural industry as a mechanism of price discovery and a risk management tool for farmers.

Commodity futures trading laws in the U.S. started primarily as aservice to the agriculture industry as futures markets developed for various farm commodities. Over the years the futures industry has rapidly expanded into markets such as energy products, metals, currencies, securities, and other financial instruments.

As a result, agriculture has become a much smaller part of the overall total exchange. In 2002, agricultural commodities accounted for only about 5 percent of the total futures contract volume actively traded in the u.s. With the rapid expansion of the futures industry into other markets, agriculture sometimes does not get attention in ways that might better serve the average farmer to help them buy and sell futures contracts so that they may better manage their risk by utilizing futures marketing.

I would suggest, Mr. Chairman, that maybe Congress, the CommodityFutures Trading Commission, and the futures industry should be looking at different ways that we can accommodate farm producers to better manage their own risks by utilizing futures contracts to hedge their commodities. Some possibilities for encouraging the use of the futures market maybe to lower transaction fees or futures margins, to offer more types of futures contracts with regards to specifications such as size, or to offer producers more options by looking into the possibility of expanding into new markets such as fertilizers, spray, seed, et cetera. Hedging on the futures market is an important tool that farmers can use to manage their own risks and we should continue to look for innovative means by which we can facilitate utilization of the futures market.

Mr. MORAN. Mr. Newsome, I would like to reiterate what Mr. Peterson said. As we deal with those, the industry that you regulate and its customers, the Commission is getting high marks and its chairman receives those marks as well. We are delighted to have you before us as our first witness on this series of hearings, and you may——

Mr. POMEROY. Mr. Chairman?

Mr. MORAN. Yes, sir. Mr. Pomeroy.

Mr. POMEROY. Could we vote on something?

Mr. MORAN. Not at the moment, Mr. Pomeroy. Knowing you as well as I do, we probably won't recognize you again throughout the remainder of the hearing. You may try later, sir.

Mr. Newsome, I thought this might be a dull and boring hearing, but Mr. Pomeroy has arrived. But we will begin with your testimony and we are delighted to have you.

STATEMENT OF JAMES E. NEWSOME, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

Mr. NEWSOME. Thank you very much, Mr. Chairman and members of the subcommittee. I certainly appreciate the opportunity to be here this morning to testify on behalf of my fellow commissioners: Commissioner Barbara Holum, who is the senior member of our Commission and has provided great leadership over the years, particularly as chairman of our Global Markets Advisory Committee. And then our newer commissioners: Commissioner Walt Lukken, who is in the audience today. Walt, of course, brings a wealth of experience from Capitol Hill and was the primary staffer for Senator Lugar as the CFMA was drafted, and we appreciate the background and the technical expertise that Commissioner Lukken brings to the Commission. And then our other new commissioner, Commissioner Sharon Brown-Hruska, who is a Ph.D. financial economist, has been in the academic arena for a number of years, and brings as well a great background to the Commission. And I appreciate the opportunity to work with each of them. We have a very cooperative and coordinating environment at the Commission, and I certainly think that is healthy for both us and for the marketplace.

The commodity futures and options markets play a critically important role in the U.S. economy. Today, I would like to briefly describe some of the most significant developments since the passage of the CFMA 2½ years ago. My written testimony explores each of these issues and several others in greater detail, and I would ask that that be included in the record, Mr. Chairman.

Mr. MORAN. Without objection, so ordered.

Mr. NEWSOME. Our mission is twofold: to foster transparent, competitive, and financially sound commodity futures markets that operate free of manipulation and distortion; and then to protect users of those markets from fraud and other abusive practices. Historically, as you well know, commodity futures were traded primarily on agricultural products, and gave farmers, ranchers, distributors, and other users of the product, a very efficient and effective set of tools to handle price volatility. The success of these risk management efforts was recognized by those outside of the agricultural sector and the model was adapted for other uses, and included contracts to manage volatility and interest rates, stock market indices, and foreign currencies.

These new contracts, following the success of agriculture futures, have enjoyed rapid growth because they have come to serve the risk management needs of businesses in virtually every sector of the economy. Trading in the financial contracts now is almost nine times that of the trading volume in agricultural contracts. While farmers and ranchers continue to use futures contracts to lock in prices for their crops and livestock, manufacturers now can also use foreign currency contracts to reduce uncertainty over the prices that they receive for finished products sold overseas. Mutual fund managers can now use stock index contracts to protect against market volatility and effectively put a floor on portfolio losses. And corporations in every sector of our economy can use contracts on U.S. Treasury instruments to manage their exposure to interest rate volatility.

To fulfill its mission, the CFTC has traditionally focused on integrity. We seek to protect the economic integrity or the markets so that they may operate efficiently, free from distortions or price manipulations. We week to protect the financial integrity of markets so that the insolvency of a single firm does not become a systemic problem for other firms or clearinghouses. And then we seek to protect the operational integrity of the market so that transactions are executed fairly, proper disclosures are made to customers, and fraudulent sales practices are not tolerated.

Over the years, the Commission has brought numerous enforcement actions against those who have attempted to manipulate or distort market prices. Recently, our most prominent cases, some resulting in multi-million dollar penalties, have involved certain energy markets. I should note that we approach the issue of whether we have jurisdiction over any particular transaction solely on the basis of its economic substance. Therefore, where we have brought charges alleging operation of an unregistered futures exchange for contracts that have been labeled as “swaps”, as we did in the Enron case, it is because the economic substance of those transactions was that of futures contracts.

Let me assure you, Mr. Chairman, that we are not seeking to expand the scope of our jurisdiction over other transactions, such as true swaps and forwards, that Congress appropriately excluded through the CEA. In the case of the over-the-counter swaps, for example, such an exclusion was expressly provided by the CFMA following recommendations by the President’s working group on financial markets, and I believe that this brought much needed legal certainty for counter parties in this important sector.

Legal certainty and regulatory clarity are important for the efficient operation of markets. We believe the best deterrent to wrongdoing is to pursue tough enforcement actions against those who choose to operate outside the established rules, rather than issuing more numerous and more prescriptive regulations that adversely affect legitimate business activity.

The CFTC’s first task under the CFMA was to modernize the rules affecting trading facilities, both traditional and the new electronic commercial markets permitted by the CFMA. Those rule modernizations have been successfully accomplished. Next, coordinating with the SEC, as determined by the CFMA, we were able to put into place the rules to allow trading of domestic security futures. And in fact, two exchanges are currently trading those products now.

We are well underway with efforts to modernize the rules affecting clearinghouses, futures commission merchants, pooled investment managers, and other intermediaries in the futures marketplace. We have identified a number of areas where improvements can be made, from enabling financial institutions overseen by other regulators, such as banks, insurance companies, and mutual funds, to use the futures markets without subjecting themselves to duplicative regulation, to providing appropriate registration relief to pooled investment vehicles that restrict participation to sufficiently well sophisticated persons, to affording FCMs with greater operational flexibility to give their customers the most efficient trade executions.

We are also well underway with efforts to design an effective oversight framework for clearinghouses, which is discussed later, occupy a new place in the regulatory landscape since the passage of the Commodity Futures Modernization Act. The CFMA may open the door for great change in the marketplace, as well as at the CFTC.

The U.S. commodity futures and options markets continue to grow rapidly. Total volume rose by more than 33 percent from 2000 to 2001, and again, by more than one-third from 2001 to 2002, as increasing numbers of companies and investors avail themselves of the risk management tools offered by these markets. While the traditional U.S. futures exchanges are enjoying record volumes, not all the growth is taking place there. Newly designated contract markets approved by the Commission since the passage of the CFMA are achieving significant trading volumes with new products and new platforms as well.

Other key trends in the market include continued migration of trading from open-outcry trading on the exchange floors to electronic trading from widely dispersed locations, a move from purely member-owned exchanges to publicly-held trading facilities, continued globalization, and of particular note, the decoupling of trading activities from clearance and settlement systems. The CFMA made express provision for this last transformation and we are already starting to see activity in this area with recent announcements of new relationships among exchanges and clearinghouses that would have been hard to imagine just several years ago.

As volumes increase, as market participants have greater choices in products and trading platforms, and as clearing and settlement functions evolve, the work of the CFTC is changing in ways that present new and exciting challenges. Under the CFMA's principles based approach, we now work even more closely with exchanges, clearinghouses and firms who have much greater flexibility in how they choose to satisfy the fundamental objectives of the core principles and alternative ways. Gone are the cookie-cutter approvals that dictated the same approach for every institution.

While we believe that market users will benefit greatly from innovative uses of technology, better customer service, greater liquidity, and more efficient transactions, we recognize that the commission and staff will have to work harder than ever to fulfill our important public mission.

Mr. Chairman, I am excited by the remarkable changes we have already seen since enactment of the CFMA. It was the right legislation at the right time and its principles based approach has already proven to be both workable and effective. The CFTC certainly stands ready to work with this subcommittee, the Congress, other regulators and market participants, to ensure that we keep up with developments in the marketplace. And Mr. Chairman, I would certainly be happy to answer any questions that you might have.

[The prepared statement of Mr. Newsome appears at the conclusion of the hearing.]

Mr. MORAN. Thank you very much, Mr. Newsome. Let me ask just a couple of questions and then turn to Mr. Peterson.

Exchanges, at least an exchange, began to change to the form in which they are owned and organized, demutualizing their ownership and organization. In many ways they have been self-governing. Does that change in the new organizational pattern? Does that mean something new for CFTC oversight?

Mr. NEWSOME. That is an issue that we have spent quite a bit of time looking at, thinking about. Certainly, as these initial moves have taken place, we have provided oversight of the exchange rules, changes in the rules which have allowed the demutualization. And from their rules standpoint, I don't see great questions that have arisen. From the self-regulatory standpoint, that is an area that we are getting ready to take a closer look at. In fact, I announced at a speech in Chicago last week that we are going to do an SRO review, not because there are any particular issues that have arisen; but given the number of changes that have taken place in the industry over the last 2 or 3 years of both the exchanges and the firms, we think it is prudent and responsible for the CFTC to take a look at SROs and to make sure that the same principles that applied when SROs were put into place, apply now.

So I have met with the exchanges, talked with John Damgard at the FIA as the firm representative, and we are developing kind of a structure and plan in terms of moving forward with this review, and are actually looking forward to it. I think it is responsible for the CFTC to do so.

Mr. MORAN. One of the reasons we spent a number of years in the process of reauthorization, and we heard continually from the exchanges about the potential threat if we didn't appropriately deregulate the industry, the threat from competition, foreign sources, from the ability of customers to utilize exchange services offshore. What have we seen just in the macro sense of the life of the exchanges, their ability to compete, potential changes that are around the corner with directs? Where are we in the nature of being able to compete in the world?

Mr. NEWSOME. I think the response to that question is one of the reasons that I said that this legislation was the right legislation at the right time, because I think it was very critical to provide the flexibility to the exchanges in order to allow them to compete in this very global marketplace. And I think there is a very positive story to tell, because since the enactment of the CFMA, volume has increased in the futures business greater than 50 percent. The business has, indeed, gotten more competitive and continues to get more competitive. Not only globally, but on our shores as well with designation of several new exchanges since the passage of the CFMA.

So I think the Act served its purpose in terms of creating the type of flexibility, the type of regulatory environment that has allowed the exchanges to use new technology, that has allowed the exchanges to make themselves as competitive as they possibly can be. The bottom line is it was a great act and it is working, Mr. Chairman.

Mr. MORAN. Did foreign countries' regulators change their regulations? Has there been a ride to lower regulations around the world as a result of the passage of that legislation?

Mr. NEWSOME. No, we haven't seen that, and I think there was a concern when Congress was debating, that it would become a spiral to the bottom, and that hasn't been the case at all. There were a number of foreign jurisdictions, obviously, that were intrigued with the Act. They wanted to learn a lot more about the Act. But no foreign jurisdiction that I am aware of has taken the same kind of approach as the CFMA, so we haven't seen that downward spiral at all.

Mr. MORAN. Mr. Chairman, thank you. Mr. Peterson.

Mr. PETERSON. Thank you, Mr. Chairman. Mr. Newsome, recently, the Minneapolis Grain Exchange announced that starting in July 2004 contracts, that those taking delivery on wheat contracts will have the option to designate the delivery of non-GMO wheat, and has the Commission had an opportunity to analyze this contract change, and what is the Commission's process for reviewing such a change or for monitoring it once it takes effect?

Mr. NEWSOME. We are currently looking at that situation. The Minneapolis Grain Exchange used flexibility that was provided in the CFMA to certify that contract change. So basically, what they can do is implement that contract change immediately by certifying to the CFTC that it meets the core principles. That is the direction that they so chose. After we received that certification, then we have started looking more closely at that contract. Certainly, I think the direction that they have gone with the right of the purchaser to choose GMO or non-GMO wheat raises some potential issues with regard to the grain facilities and their ability to gather, store the different types of wheat. So over the last several days, we have begun to review that contract certification. And Congressman, I would be more than happy, as we get more involved in that and figure out more about it, to come by and visit with you about the issues that have been raised.

Mr. PETERSON. I would appreciate that. And is there also an issue of, I don't know, in terms of testing to make sure it is GMO free? Is that part of what you have to look at or not?

Mr. NEWSOME. Yes. I mean, anything that affects the efficient delivery of the contract is something that we would be interested in. And if testing prohibits or makes inefficient the delivery process, then, certainly, that is an issue. And it is my understanding that there are two forms of testing available; one rather simple, one more complex. One test is used to establish whether it is GMO free or not. The other is used to establish what the percentage of GMO is within that load. And it is my understanding that the second test can even take up to a number of weeks.

Mr. PETERSON. I would appreciate you keeping me informed on what is going on with that.

Mr. NEWSOME. Yes, sir.

Mr. PETERSON. You mentioned that the single stock futures volume are in line with volumes you have seen at some of the other now proven products that you have brought out. What do you know so far about who is trading these products and are retail investors using them to any significant degree?

Mr. NEWSOME. No, sir. We have yet to see any significant retail activity in these products. I think given the situation with the underlying stock market over the last several years, we are just not seeing a lot of new activity or a lot of new business, and that flows over into the security futures products. The volume is very institutional at this point. I think we are starting to see some increases in that volume. After exchange launches volume increased, it kind of leveled off for a several month time period, and then more recently, we are seeing that volume starting to increase again.

Mr. PETERSON. I don't know if I understand completely how all this works, but it seems to me that it is kind of the same thing as buying an option. I mean, you buy an option, put a call, and kind of doing the same thing only with a different product. Right?

Mr. NEWSOME. It is similar. It is, actually, probably a little less complicated than buying an option, and that is one of the reasons for the excitement of the product. The two exchanges that have begun trading. One, Chicago and NASDAQ LIFFE, I think remain very excited about the potential of the product. There is no question it was a very difficult time to launch any new product in the financial services arena, so I think it is quite amazing that they have done as well as they have given the underlying circumstances.

Mr. PETERSON. One last question. Apparently, when this was set up, the SEC was—some of the participants in the cash security industry were concerned about this. Is the SEC still concerned, and apparently, you have worked out the way you regulate this between them. Could you just comment on where that is at?

Mr. NEWSOME. Yes, sir. There is no simple way to put it. It was a difficult process. It was more difficult than I think anyone ever envisioned that it would be. It took us longer, certainly, than we had hoped. But the difficulty stemmed from two very different market places, two very different regulatory schemes that have developed over time, and appropriately so. But trying to take those two regulatory schemes and mold it together to try and develop a legitimate, appropriate regulatory scheme for the trading of this one product area, our staffs worked diligently. At the Commission level, we worked extremely hard to bring this to fruition.

In fact, just as of last night, I would mention Commission Walt Lukken at the CFTC, Commissioner Paul Atkins at the SEC, have been tasked by both commissions with trying to finalize the couple of remaining issues that we have. One of those was further defining the role of the primary regulator versus the notice regulator, and I think as you and Congress set up the regulatory structure, I think your intent was to make sure that market participants didn't have to answer to two full regulators through the trading of this product. And so we have taken the time to develop this primary regulator and what the responsibilities are of the notice regulator to make sure that market participants didn't have to answer to two. And Commissioner Lukken told me this morning that we have, in fact, finalized that agreement with the SEC that further defines those roles, and I think that is extremely positive for market participants in terms of kind of the regulatory certainty

But it was a difficult process. I think we developed a very appropriate regulatory structure for this product that gives it an opportunity to compete and flourish in the marketplace if market participants so choose.

Mr. PETERSON. Thank you, Mr. Chairman.

Mr. MORAN. The gentlewoman from Colorado, Mrs. Musgrave.

Mrs. MUSGRAVE. Thank you, Mr. Chairman.

Under the paid provision parity that we are granted under the farm bill, can you tell me how that has affected your ability to hire and retain staffers with expertise in the area?

Mr. NEWSOME. It has been dramatic. Our reason for asking for pay parity, as we call it, was because we were experiencing roughly a 20 percent annual loss in our attorneys and a 15 percent annual loss in our economists. And as you would expect, some were moving to private sector jobs, but a big portion of those losses were going to our sister financial agencies for similar positions at higher pay. So giving us that authority almost immediately stemmed those losses of employees to other agencies. We implemented that as quickly as we could. In fact, I think staff at the CFTC were amazed that we were able to implement pay parity as quickly as we did, and we have seen our turnovers fall dramatically since that time. It has been very beneficial to us.

Mrs. MUSGRAVE. Thank you, Mr. Chairman.

Mr. MORAN. Thank you very much. Mr. Etheridge, the gentleman from North Carolina.

Mr. ETHERIDGE. Thank you, Mr. Chairman. I want to thank you and Mr. Peterson for holding this hearing. Chairman Newsome, let me follow-up just a bit on the single stock futures, if I may, that was created by CFMA. You mentioned that single stock futures volumes were in line with volumes seen in the early days of other now successful products. My question is, if the top seven exchanges are overseas, according to the data I have here, from what I have looked at, if these types of products still need to prove themselves, why are these products finding such favorable foreign markets? Is it simply because foreign markets are more mature and have been trading these instruments longer than we have or is it a matter of the different regulatory regimes governing those markets versus our markets, or does it have to do with the U.S. investors' confidence and knowledge of the instruments and how we used them here in this country in the short period of time we have had them?

Mr. NEWSOME. Thank you, sir. I think it is almost entirely the maturity of the marketplace, because these products have been legal in foreign jurisdictions for many years and have been trading in foreign jurisdictions for a number of years, and they are relatively new to the U.S. And then again, the launch of those products in a very difficult time period, I think, has made things a little harder for them. The reason that we put together those numbers, there were a number of publications who are starting to write about the demise of the products. They weren't as successful as some indicated, as others thought they would be. So we just took the time to look back at what are now some benchmark products and try to compare during the same maturity and look at where they are and the results were surprising. So we have tried to use that to say, let us give these products a chance. I think the marketplace is giving them a chance, volume is increasing, and I still think the opportunity exists for those to be very, very large popular products.

Mr. ETHERIDGE. I hope you will keep using the chart so at least you can track from year to year where we are.

Mr. NEWSOME. Yes, sir.

Mr. ETHERIDGE. Let me move to another question, because the Commission has been deeply involved in the aftermath of the western power crisis that hit this country in 2000 and 2001. There is a Senate bill pending that would, among other things, alter the law and the CFTC's authority with respect to the over-the-counter derivatives on energy products. What is the reaction of the Commission to this piece of legislation and the concerns that it represents if there are concerns? And recognizing that all the investigations are not complete, and I understand that, what have we learned so far about the types of regulatory modifications that should be considered that, obviously, we may be looking at in the near future?

Mr. NEWSOME. Obviously, this has taken a lot of our time over the last year, year-and-a-half, studying the energy markets, the investigations that we are involved in, and a number of those, as you commented, are ongoing. I think as we step back and we try to look at the big picture of what the Government response should be from the futures markets, I would simply say this, that this Congress spent over 2 years meeting with market participants, holding a number of hearings, and I think doing appropriate due diligence to craft the Commodity Futures Modernization Act. And it was very good, appropriate legislation; I think still remains appropriate. And I think any changes to that should follow just as responsible an approach in terms of hearings and meeting with market participants, because the reality is very small changes to the act can have huge consequences in unintended areas. And so I think before any changes should be made, the committees of jurisdiction, this committee and the Senate Agriculture Committee should be very involved in looking at potential changes and what consequences may or may not be.

Some of the concerns that the Commission has had with issues that have been raised, such as regulating the over-the-counter marketplace the same way that the exchanges are regulated on the surface sounds legitimate. But then when you look at the underlying functions of those two marketplaces and you realize that off exchange is bilateral, one entity to another entity versus the bigger public marketplace. It creates very real differences, and it has even put me in a situation that I have had to argue against transparency, and arguing against transparency is like arguing against motherhood and apple pie.

Mr. ETHERIDGE. I will agree with that.

Mr. NEWSOME. But the difficulty, I think, in looking at exchanged-traded of markets and how transparent they are versus the over-the-counter marketplace. On one hand you have a very transparent marketplace. Everyone knows the underlying terms and conditions of the contract, so price is meaningful. But on the other hand, where every contract could have differing terms and conditions, price is not necessarily meaningful unless you know everything that underlies it. So my concern has been that if you made transparent all this pricing information without knowing what underlies it, that that could actually have a negative impact upon the price discovery function of the contracts that we depend upon.

So I think some things that sound legitimate, once you look into them, can become very difficult, and I would just use that as an example.

Mr. ETHERIDGE. Thank you, Mr. Chairman. I want to follow that up in the next round if I have a second round.

Mr. NEWSOME. Yes, sir.

Mr. MORAN. Thank you, Mr. Etheridge. The gentleman from Washington, Mr. Larsen.

Mr. LARSEN. Thank you, Mr. Chairman. If you don't mind, Mr. Etheridge, I will follow-up a little bit with that. Being from Washington State, the State was devastated by the energy market and energy crisis 2000, 2001. In 1 day alone, my morning conversation started with some folks who were involved in the energy market who were buying on the stock market for, I think it went from $25 to around $250. By the end of the day, I saw those folks again, and they said the price was actually at infinity. In other words, they didn't have enough cash to buy on the market. That is the spot market, but that is sort of the flavor of what we were dealing with in the Northwest. And so I want to refer back to the Senate bill that Senator Cantwell and others have introduced.

I note your concerns. Are there parts of that bill that you have looked at that you think you ought to be moving towards? You can have concerns about legislation, and I appreciate those concerns. Are there things that you should be—that the bill outlines with regards to your authorities that you would like?

Mr. NEWSOME. I think our regulatory oversight deals with the futures business.

Mr. LARSEN. Sure.

Mr. NEWSOME. Of course, the exchange-traded business. And then with regard to the over-the-counter business, the CFMA provided no upfront regulatory responsibilities after the fact, fraud, and manipulation responsibilities. And we have used those responsibilities very aggressively over the last 2-year period and have brought a number of charges against several energy trading companies. We are continuing to investigate and there may very well be more. As this whole situation has unfolded, certainly, it appears the more issues are more related to the cash markets, the spot markets, than they are to the futures market, so I think, appropriately, FERC, as the spot regulator, rate setter, I think has been more involved with the energy committee in the Senate with regard to oversight of cash marketplaces.

To the extent that some of that language has flowed over into the futures business in our jurisdiction, we have just continued to say use caution, when you cross that line and flow over into the OTC or the futures business, I continue to believe that the CFTC has the proper authority from the anti-fraud, anti-manipulation standpoint to do the job that you intended us to do when you passed the CFMA. If Congress decides that the CFTC should serve more of an upfront regulatory role in this marketplace, I just think that there needs to be a larger debate with market participants involved who are extremely knowledgeable about the Commission and our surveillance efforts, and I fear that debate hasn't been held enough to look at what are all the potential pitfalls or the unintended consequences.

Mr. LARSEN. You have taken some actions and you have outlined those in the testimony, but are you learning from those actions that, though you don't have authorities, that you would like to have?

Mr. NEWSOME. Well, we are certainly learning from the actions and our investigations. I think there are a couple of areas in which our jurisdiction could be further clarified, our enforcement authority strengthened, that would make it easier for us to do the types of investigations that we are currently doing.

Mr. LARSEN. And do you have those areas in mind?

Mr. NEWSOME. Well, for example, in terms of our general fraud authority, the language says "for or on behalf of", and it is old language. Well, in the over-the-counter marketplace, trading is not "for or on behalf of", because it is between two participants.

Mr. LARSEN. Right.

Mr. NEWSOME. And that language has created some difficulty for us in court, and clarification there so that there is absolutely no doubt that we have that type of authority over a bilateral transaction would be helpful.

Mr. LARSEN. That is an example. Okay. Thanks, Mr. Chairman.

Mr. MORAN. You are welcome. The gentleman from California, Mr. Dooley.

Mr. DOOLEY. Thank you and I appreciate your response in terms of how we should approach some of the issues related to the energy issues that primarily affected the west. From my perspective, we also have to be careful in terms of advocating any significant reforms in terms of the functions that you are involved into now, or even broadening authority of over-the-counter transactions, because in part, it was a California approach that really contributed to the abuse of the system, in that when they had prohibition—well, almost prohibitions—against entering into long-term contracts, and in fact, took away one of the principle tools in terms of managing volatility, which is what the exchanges and the contracts which you are involved in can really provide that function.

I think we have to be very, very cautious, and I let you know from one California's perspective, you know, I appreciate your very judicious approach to whether or not we ought to engage into even greater oversight, which would impede the utilization of contracts between two parties, and also acknowledge that we need to ensure that the function that you do play in allowing the exchanges to be utilized in order to manage volatility, which is a principle function they could play that can help protect some of the parties in this if they engaged in this, you would have had some of the principles out there that wouldn't have been exposed to the tremendous losses they had.

At this time, don't have a specific question on this, but would just like to reinforce my appreciation for your very judicious approach, because if we do enter into over-the-counter contracts, I think we are opening—we are actually going to then eliminate a tool that is going to be very important in the private sector.

Mr. NEWSOME. Thank you very much, Congressman.

Mr. MORAN. The gentleman from Louisiana. No questions? Any members like a second round? Mr. Peterson.

Mr. PETERSON. Thank you, Mr. Chairman. I am probably going to get in trouble asking this. I don't claim to understand much about this, but I have had some discussions with people in the oil business that claim that the big guys will go out of the futures market and hedge their price, and then they control so much of the market that they run the price down on purpose and put the little guys out of business, put the ethanol industry in jeopardy, and so forth. I assume that that is part of what you look at, and can you disabuse me of this idea?

Mr. NEWSOME. Yes, sir. Quite often, our Enforcement Division gets more of the highlights because they are bringing the cases against wrongdoers, but the heart and soul of the CFTC in trying to prevent any fraud or manipulation comes through our surveillance division. And we monitor daily every futures market traded, we receive what we call our large trader reports every day that look at every marketplace and show who is trading in the marketplace, what their positions are, and it allows us to get a pretty quick handle on whether or not things are operating correctly or if anyone is trying to corner a marketplace.

Let me say that we have very experienced economists in energy, financials, agriculturals, who have these responsibilities, and if at any time there is a question about a major market participant who has taken on a large position, they will actually get a call from our surveillance economists to say, we see that you have taken this position, can you explain the underlying economics to us. If those underlying economics are sound, then they have at least been put on notice that we are watching their activity. If the underlying economics do not appear sound to us, then we will actually ask them to start unwinding that position. If they fail to do so, then that gets turned over to our Enforcement Division to start an investigation. So Congressman, we look at those markets every day and we look at the specifics of them.

Mr. PETERSON. Have there been instances where you have had told them to unwind whatever they are doing?

Mr. NEWSOME. Oh, by all means. That is a normal part of our activity.

Mr. PETERSON. That usually gets taken before it gets into the—usually gets resolved before it gets into the enforcement?

Mr. NEWSOME. Yes. We try to use the surveillance as an opportunity to prevent manipulation before it ever really gets started.

Mr. PETERSON. Thank you, Mr. Chairman.

Mr. MORAN. Mr. Larsen.

Mr. LARSEN. Thank you. I have a—it is almost the same question, but I can make it related so you are not repeating your answer, though. You mentioned in your testimony about a case against natural gas or an energy trading company that was manipulating the natural gas price. And I was wondering—you described the process of how you go about watching the markets, generally. And this could get into Mrs. Musgrave's questions about staffing. How many cases do you think, or how many—it wouldn't be a case unless you brought it to a case, but how many do you miss, do you think, for as many as you find, and do you have enough resources to make sure that number is close to zero?

Mr. NEWSOME. It is impossible——

Mr. LARSEN. How does that work?

Mr. NEWSOME. It is impossible for me to say how many we miss. We try hard not to miss——

Mr. LARSEN. My question, though——

Mr. NEWSOME. I think given our current jurisdiction, that a staffing level in the mid to upper 500's is an appropriate staffing level for us. We are currently below that. We are at like 510 FTE's at the Commission now. In recent years, we have been as high as 600. As we were addressing our needs over the last 2 years, the most important need was to stop the exodus of qualified people from leaving, and therefore, we asked for and were granted from you our pay parity authorization. And so we have stopped that exodus. It would be my hope that now, over the next year or 2 years, with funding from Congress, that we can get back up to that mid–5 level. I am very comfortable at that level. I don't think at our 510 level that things are falling through the cracks, but our staff have been working awfully hard for a couple of years and it does concern me.

Mr. LARSEN. Okay. You mentioned some additional charges that you may file as your investigation in the inner sector continues. I know you can't share specifics of the cases, but in a general sense, what type of violations we might—can you characterize the kinds of violations you might foresee in the future?

Mr. NEWSOME. Well, let me say, typically, at the Commission, we would have 100 investigations ongoing at any one time in a broad range of areas. During the last 1½ years or so, we have had roughly 30 just within the energy sector itself. But I think most of the things, in trying to answer your question without getting in trouble, I think most of the things that we are looking at now are very similar to things that have been made public.

Mr. LARSEN. Okay. One of the great things about this job up here is we get to ask questions and you all have to find a way to answer them, so I appreciate that very much.

Mr. NEWSOME. Thank you.

Mr. LARSEN. Thank you, Mr. Chairman.

Mr. MORAN. You are welcome. The gentleman from Georgia.

Mr. BURNS. Thank you, Mr. Chairman. I appreciate the opportunity to learn more about the challenges that you face every day in the commodities futures trading environment. Let me ask a couple of things that relate to your role with the SEC and how that works out as far as single stock futures products. Is that a relationship that is working effectively and how would you term that?

Mr. NEWSOME. I think the relationship is working effectively. In terms of developing the rules to govern security futures, it was a hard process, I think harder than anyone ever envisioned. It was difficult at the staff level, it was difficult at the Commission level, in trying to take two different regulatory schemes and meld it into one for the trading of this product area. And I think when you look at the different regulatory schemes, they have developed appropriately so over time, but it was just hard. And I am very proud of the regulatory scheme that we finalized. I think it is appropriate. I might add that it is very futures-like in the way it appears. And in my opinion, the regulatory scheme should not inhibit the potential success of the product.

Mr. BURNS. So you would see no need to revisit that. You feel comfortable with that resolution?

Mr. NEWSOME. Well, I think as time goes on and as situations develop, regulatory situations, and we look at the response from the CFTC and the response of the SEC, I think we will learn more about it and can probably then more appropriately advise you on whether or not it needs to be reviewed. There are a couple of issues that remain outstanding. Well, maybe just one, because I was told by Commissioner Lukken that we resolved one last night. But Commissioner Lukken from the CFTC and Commissioner Atkins from the SEC have been playing a leadership role in our two commissions to finalize the last couple of issues.

One that was finalized last night was simply further defining the role of the primary regulator and the notice regulator to make sure that firms and exchanges didn't have to answer to two different regulatory structures. We thought that was extremely important and it appears that we have finalized that. The other issue, which is a more difficult issue, is dealing with foreign access to these products, and the CFTC a number of years ago addressed the foreign access issues in the futures business by recognizing what we considered comparable regulatory jurisdictions. The SEC is not at the same point. They are currently looking at how they intend to address the more globalized marketplace. I think they wish for the debate on this one product not to drive the bigger debate that they are currently having, so I don't feel like we are making a lot of progress currently on that last remaining issue.

Mr. BURNS. Thank you. Shifting gears a bit, being a former cattleman and cattle executive out of Mississippi, and being in the cattle business, let us talk a little bit about the effects of food safety on the market, on the futures market, especially, things that happen on a global scale, sometimes a little closer to home than we would like. How does that impact your business and, really, the stability of the futures environment?

Mr. NEWSOME. Well, I think that raises several points. Anytime there is information that enters the marketplace that leads to price volatility, we immediately increase our market surveillance in that contract market, which is what we did with the BSE situation 2 weeks ago. Not only do we increase our surveillance both in the pit where it is trading and through looking at the screen and a larger section of the large trader report, but we also start calling people that are involved at that marketplace, finding out what is the mentality, what is going on. I mean, it is just a much more enhanced surveillance than we typically would do. We also then would work with the regulator in the underlying cash market, in this case USDA, to start finding out what were the timelines that information was released, and then compare that back to major shifts or trading activity just to get a better picture of what happened, when it happened, who did it, and so on. So I think that is the first thing, we increase our surveillance.

Second, I think it is important for everyone to recognize that once you get an announcement like that and it is conformed, that becomes a market fundamental, and the markets are going to trade based on that fundamental. In this case, it was very negative, the market was limit down. We have stop gap measures in place, circuit breakers, trading halts, that when volatility becomes great, and say, it moves to a certain level in a contract that trading would halt for a short time period to give those in that market time to gather their thoughts before that market begins trading again. And then if it gets to a point, then trading is halted as it did with the limit down in BSE.

So I mean, we have measures in place to try and deal with that kind of volatility that could come from a large announcement, but there is no question that confirmation of information like that can lead to great volatility, and we increase our surveillance. I think we have got mechanisms in place to deal with it, certainly, in a short-term period.

Mr. BURNS. Thank you. I just want to make sure that you feel comfortable with your ability to deal with those kinds of challenges.

Mr. NEWSOME. Yes, sir. Thank you very much.

Mr. BURNS. Thank you, Mr. Chairman.

Mr. MORAN. Thank you, Mr. Burns. I thought, perhaps, the gentleman from North Dakota took me at my word and removed himself from the subcommittee, but he has returned, and I reluctantly call upon the gentleman and my friend from North Dakota.

Mr. POMEROY. Mr. Chairman, I was deeply hurt, but I stepped out and composed myself. I can continue.

I want to begin by commending the chairman. I recall a hearing some while ago where we had the Secretary of the Treasury, the chairman of the Federal Reserve, and the chairman of CFTC, or the chairman of the SEC as well, and it was 3 against 1 in terms of how they viewed the world ought to unfold, and that was, in my opinion, a completely untenable position for CFTC, and I am delighted to hear about the integration of regulatory strategies and the continued role of CFTC, because I think that actually had come into issue in light of the incompatibility of approaches earlier. So good work there.

As an old insurance regulator, I am intrigued by the whole business of insolvencies of market participants. You had some extraordinary hits in light of the way markets have gone, and currency fluctuations more recently. Are people that are taking the risks that has laid off in some of this future trading, have they been able to bear the hits that have been borne? I haven't read in the financial pages about much insolvent activity.

Mr. NEWSOME. No, sir. Nor has there been any. I mean, these markets are very large and liquid, and that risk gets passed out in many, many directions. And even with the kind of volatility that we have seen, that risk has been managed. And I think that is what has led Chairman Greenspan to make the kind of comments he has made about the resiliency of our economy and the ability to share and lay off this risk through much greater use of the derivatives markets, and I think that is exactly what has happened.

Mr. POMEROY. That is impressive. At the time we passed the reauthorization bill, there was a lot of discussions about the emerging competitive station of the markets in Europe and, basically, the electronic globalization of how all this business is done, and our need to keep our markets competitive. What has happened relative to business since? Has it continued to move to the other markets or have our markets remained competitive?

Mr. NEWSOME. I think our markets have remained very competitive, in a large portion due to the Act and the flexibility that was created with the Act. But this industry is growing, and it is growing globally on a very fast pace. Like I said, volume at our exchanges is up over 30 percent each of the last 2 years, which is just tremendous growth. So even though I think we are seeing greater competition within the futures marketplace than this market has ever experienced, at the same time, we have tremendous growth. I think our exchanges are, even more so today, making decisions to position themselves to compete in this marketplace as new and experienced competitors are coming in the door.

But I think we are seeing just a very exciting dynamic marketplace in the futures. I think it is going to continue to grow and change very rapidly over the next three or four years. And the flexibility that the Act gave not only to the exchanges, but to the regulator, to be able to adapt and develop with these many changes was critical. It has been very helpful to us.

Mr. POMEROY. Chairman Ewing did a nice piece of work with that legislation. I didn't think we were going to get it done; at the 11th hour, we passed it. I am glad it is working. A final question. There are a couple of final questions. I have seen at least one effort, maybe two, to try to get an insurance future traded. No takers on that one?

Mr. NEWSOME. Not that I am aware of. I haven't seen anything lately.

Mr. POMEROY. All right. Final question.

Mr. MORAN. Mr. Pomeroy, only in politics is there more than one final question. This is your final.

Mr. POMEROY. This will be your final answer. Enron. There was a lot of speculation about market manipulation during the energy crisis in California. I am very pleased about the follow along regulatory activity. The only concern that I have is it is after the fact. Was there more, as you do your lessons learned analysis, that could have been done by the agency during the pendency of the energy crisis to determine whether or not there was some illegal manipulation in the market?

Mr. NEWSOME. It is hard to say. There are a number of areas in which we have jurisdiction after the fact. And one, as an example, is the Retail Forex issue that you clarified as part of the CFMA, and since that was clarified, I mean, we have brought some 3 dozen cases in that area and put a huge dent in that illegal business. But in an area like that in which our responsibility is all after the fact, we, typically, rely upon complaints. And we put out the kind of fact finding missions to find out what is going on, who is doing what, but customer complaints who think they are being wronged is our typical way of having the flag raised, and that was just not the case.

Mr. POMEROY. You weren't getting complaints?

Mr. NEWSOME. No, we were not getting complaints.

Mr. POMEROY. Well, I was reading in the papers the Governor and every other either politician or consumer advocate——

Mr. NEWSOME. No, but since then. But I am talking way in advance.

Mr. POMEROY. Oh, OK.

Mr. NEWSOME. As that market was evolving, there were no complaints so, therefore, no reason for us to really look into it. I think as we have worked in our investigations, and I think there are some things, and this went some to Mr. Larsen's question of some kind of notice filing, so that we just know who the participants are in the marketplace, making sure that they are required to keep good records so that if we do have to come in, we are guaranteed that there is going to be something there for us to look at. I think those kinds of things could be helpful to us with our after the fact regulatory scheme.

Mr. POMEROY. I agree with that, and probably would also—I expect you do this—note new product and trading activity in critical industries like energy, because of its kind of evolving or embryonic state, it is not a mature market with a lot of participants and established ways of dealing, that probably is going to also require much more oversight, because the market forces themselves have yet to gel.

Mr. NEWSOME. Well, one issue, and it is an ongoing issue, is credit availability in that segment of our economy. And I think it raises another issue of how good the CFMA was regarding its flexibility, because clearing and the ability to clear over-the-counter contracts immediately came to the forefront. And so now we have exchanges, NYMEX, Intercontinental, who are actually clearing over-the-counter contracts, which has helped the credit crunch that the energy sector has been in. So that is just another example of how the Act was very far-reaching in its approach.

Mr. POMEROY. Thank you, Mr. Chairman.

Mr. MORAN. Thank you, Mr. Pomeroy. The gentleman from Mississippi, Mr. Pickering.

Mr. PICKERING. Mr. Chairman, it is always good to be with you.

Mr. MORAN. Thank you so much.

Mr. PICKERING. And it is good to have an adopted Mississippian, a true Mississippian, Jim Newsome, here, and his able Chief of Staff, Scott Parsons. I wanted to follow up on some of the questions that have been asked and possibly pursue some other areas as it relates not only to the Canadian beef situation, but to the energy markets.

First, I know that you have been increasing your market surveillance with the Canadian beef. When do you see that situation changing as far as Canadian beef coming back into our market, and how will that affect the markets and the prices that we now see?

Mr. NEWSOME. I don't have any intelligence on when the border might be opened, but we have been asked by USDA to provide some input in terms of what day of the week or what time of the day when that announcement is made could be most helpful or less disturbing to the marketplace itself, and we have provided that type of information to them. But we are going to continue to have increased surveillance in the live cattle market through whenever that announcement is made, and then some time period afterwards, as that marketplace settles out.

Mr. PICKERING. Do you have any indication of how significant the backlog is as a result of the Canadian beef not being in the U.S. market? And then just how significant when it comes back on that could affect our prices?

Mr. NEWSOME. I don't have that data at my fingertips, Congressman. But certainly, we can supply that to you. I think the most dramatic impact is going to be from the fed cattle side versus the feeder cattle side, because the fed cattle marketing it is important to stay more current because of the weight and the condition of those cattle. And I am sure that it could have a significant impact once it is opened.

Mr. PICKERING. I would also like to ask you if you have had a chance to look at the energy bills that are going through, that has gone through the House, is pending in the Senate, and as you know, not only did you go through the Modernization Act and now the implementation, the post Enron and various enforcement actions that you have taken as a result of the fraudulent activities, but we are taking some pretty major reform steps, modernization, in the energy industry structure, repealing PUCHA, reforming PURPA, and other regulatory initiatives. Do you think that will affect your work in any way? Will it help, hurt, benefit, or have you looked at those in any way?

Mr. NEWSOME. I haven't looked closely at those. Quite honestly, I have difficulty keeping up with everything that is under our purview without worrying about others. Anything that assists the energy business in terms of credit enhancement, increasing market participation, creating stability in the underlying cash markets there, those kinds of things are certainly very positive for energy trading in the futures markets, and we would be supportive of such.

Mr. PICKERING. And finally, after September 11, and we saw some of the disruption in the financial markets, and the uncertainty, we are now getting back to a place where we are beginning to see the earnings, the economic growth, the stability in the markets. What type of response capabilities have you developed since September 11 to help stabilize markets if we ever have any additional attacks on this country and how it affects us?

Mr. NEWSOME. As we reflect back on September 11, as tragic as it was for everyone, it was very personal to us because our New York office was in the first tower that went down. Fortunately, we did not lose any of our staff. They were all able to get outside safely, although, obviously, many of those that they worked with at the firms and exchanges were lost. So that hit pretty close to home for us. We have taken that situation to look both internally at our contingency plans and work with the exchanges in the firms to develop further contingency plans. And I can tell you that dramatic changes have been made both internally and externally. Both from minor things such as, how do I get in touch with A, B, and C if a disaster happens, to very complicated offsite trading systems and plans.

So there has been a lot of work. It is hard to guess and say that you are prepared for something as tragic as we witnessed, but I don't think there is any doubt that we are much better prepared now to deal with that kind of tragedy than we were. And I think our markets dealt with it very, very well with regard to September 11. I mean, anytime entire exchanges are destroyed, and within the week, you are back up and trading and discovering price, it is nothing short of amazing. But I think we are better prepared now than even then.

Mr. PICKERING. Well, Mr. Newsome, I thank you for your testimony, I thank you for your leadership, and the service to the Country. Mr. Chairman, it is always good to be under your leadership and good to be with you this morning.

Mr. MORAN. Mr. Pickering, I note the smile with which you say that. I would also note that Mrs. Musgrave has been here from the beginning to the end, and I appreciate that, the gentlewoman from Colorado. Mr. Newsome, Chairman Newsome, a couple of things, just let me try to follow through. I want to follow up to Mr. Pickering's question. Is there backup data information systems both at the CFTC and the exchanges outside separate from the computer systems that monitor, provide information and data, for the occurrence of another tragedy?

Mr. NEWSOME. Yes, sir.

Mr. MORAN. So those systems are someplace else?

Mr. NEWSOME. Yes, sir.

Mr. MORAN. There has been a lot of discussion here today about the California energy markets. Is there unanimity at the Commission in the position that you related to us today that you have stated a number of times in press and public and in front of Congress, about upfront regulation? It is the belief of the Commission that no additional statutory authority is necessary to provide upfront regulation? That is something I assume you have debated within the Commission and this is the consensus or unanimity position?

Mr. NEWSOME. I wouldn't say that we are all exactly in the same place, and nor should that be expected. I mean, we all have differing ideas. I feel comfortable in saying that the majority of the Commission does not believe that we should try to implement the same regulatory structure over the over-the-counter marketplace as we have over exchange-traded. But I think, as well, a majority of the Commission believes that there are some things that could be done to benefit our regulatory oversight in this marketplace, such as the notice registration, enhanced record keeping, clarified fraud authority. I mean, and those are things that could take place without being disruptive and overly burdensome to the markets.

Mr. MORAN. And I think the point that you made earlier was that even with additional regulatory authority, you generally begin looking at an issue when there are complaints raised by participants in the market, and even with that authority, in this case there were no complaints raised prior to the kind of disastrous times in California. Is that true?

Mr. NEWSOME. Yes, sir.

Mr. MORAN. Clearinghouse has been an issue that has risen in the last few months, and then changes are happening in Chicago in regard to at least the plan for clearing. Your thoughts, the CFTC's role in these decisions?

Mr. NEWSOME. That has been an issue that has taken a lot of our time recently at the commission, just trying to step back and take a broad look at the business and how it is structured. And my good friend, John Damgard, and I have spent a number of hours discussing clearing issues. As we have looked at it, and I guess I would say that if you are going to start from day one with a blank sheet of paper and draw out how you would ideally structure clearing, it probably wouldn't look the same as it does today. But that is not the case. I mean, we have a very mature clearing system, and it has served this industry extremely well for a long period of time.

But as we have looked at the structure of clearing, it has been difficult at least for me, personally, to find a regulatory reason for us to be involved in that decision. I think these are primarily business decisions that should and are being made by the marketplace. I think the decision by the Chicago Board of Trade and the Chicago Mercantile Exchange to combine their clearing facilities and interest was very good news for the firms and the marketplace because of the efficiencies, the capital efficiencies that will come with that, and we are working with them as they combine those entities.

The announcement recently by Eurex and the Board of Trade Clearing Corporation in terms of their agreement, and that the BOTCC will clear for Eurex was another huge business decision that I think has brought lots of excitement within the business. So from the regulator standpoint, I have been content with watching and talking to market participants about this activity, and then based upon the business decisions that are being made and then review from the Commission standpoint to decide whether there is a regulatory issue that we need to look at.

Mr. MORAN. A final—I won't use the word final or finally—hedge funds. There has been some discussion. SEC had a roundtable. It appears to me that perhaps once again we are headed in slightly different directions between the SEC and the CFTC. My impression is that they are perhaps more pro-regulatory than the CFTC is on this issue. How do you see this issue unfolding? What do we, as members of this subcommittee that have oversight, need to know?

Mr. NEWSOME. I appreciate you bringing up this issue, because it is a key issue that has been getting lots of press time and, certainly, in financial circles a lot of discussion around the water cooler. I think, even though on the surface it really appears that the agencies are going in two different directions, I think actually we are asking two different sets of questions. One, the SEC as a financial services regulator, I think is responsibly asking the question should these markets be more heavily regulated. The CFTC is asking a different question. What we are saying, we are actually trying to be intellectually honest about who should be required to register with the CFTC and who should not. For example, our current rules would require that if you traded one futures contract, you are required to be registered with the CFTC, and I don't think that is appropriate. So we are not looking at the bigger context of whether or not hedge funds should be more heavily regulated. We are simply trying to answer who should have to register with us and who should not. And we are looking at that from the standpoint of de minimis trading levels, very sophisticated market participants, entities that are already regulated by another Federal regulator. Those are the kinds of questions that we are trying to ask and make determinations on.

And I think in final comment on that question, I do believe that this could be an appropriate topic for the President's Working Group to look at because it is a huge industry. It moves across jurisdictional lines. Chairman Donaldson has stated publicly, that at the end of the day, this is an issue that he thinks the Working Group should look at, and I would agree with his assessment of that.

Mr. MORAN. The gentleman from Michigan, Mr. Smith.

Mr. SMITH. Mr. Newsome, good to see you again.

Mr. NEWSOME. Good to see you, sir.

Mr. SMITH. My speech is that we pretty much started commodity trading as a service to agricultural producers to farmers. Over the years, farming and agricultural producers have been a much smaller, lesser part of the effort of commodity trading, and certainly, your oversight. Now, agricultural trading only represents about 5 percent. If you include true hedging from farmers, then it is less than 1 percent. I would be interested in any ideas that you might have for ways that might better accommodate farm producers. I mean, this committee has oversight over your total jurisdiction, but my particular concern is agriculture and farmers.

If we were interested in having, in terms of reducing the risk of farmers, if we were interested in developing other potential changes in commodity future trading that could better accommodate farmer producer needs, do you have any ideas?

What do you think about what would have to be done if we decided that we wanted to have future contracts for potential hedging about more of the inputs that go into agriculture, for more fertilizers, to more chemicals, to more whatever, could even go as far as potential costs of all of the inputs that go into agriculture.

What would you think of the possibility of making some of the contracts which are now 5,000 bushel contracts in most of the grains a smaller figure in terms of better accommodating some of the smaller producers so that they could actually hedge rather than speculate?

What would you think of maybe even a further reduced cost that would be subsidized by the industry in terms of the transaction fees charged for farmer hedging?

Any comments? So that is a lot of load that I put on as far as some of the ideas, but——

Mr. NEWSOME. I would—and a couple of things. I tried to make some notes here to make sure that I could respond to all of your questions. I think educating farmers and I am a farm kid, and grew up on a farm, and certainly have a real love and interest in the cattle business.

So because of this committee and the Senate Agriculture Committee overseeing the jurisdiction of the CFTC, because many of us come from ag backgrounds, even though the percentage of trading in agriculture has diminished, the CFTC spends a disproportionate number of our resources and efforts in the agricultural area. In fact, the physicals, in general, by just the nature of the products and deliveries, get a large portion of our regulatory oversight and surveillance. So I didn't want you to think that we short agricultural oversight because the percentage of ag contracts is decreasing. In fact, if anything, we have spent more time in recent years on the ag area than anything else.

Educating producers of the benefits of using these kinds of hedging instruments is an ongoing struggle, and it is not an area that we, the CFTC, are that directly involved in just because of the size of our staff and budgetary limitations. But the exchanges themselves expend huge amounts of resources on meeting with producer groups and trying to educate them about the use of the markets. I know just recently, the Chicago Mercantile Exchange is meeting with cattlemen's groups in several places around the country to try to educate them about the usefulness of the live cattle contract, and that goes on in a number of other areas as well. So the exchanges themselves put forth a lot of effort.

We work through the advisory committee of the Risk Management Agency at USDA, who does have the bigger budget in terms of working with producers on risk management issues, and in some new literature in a new program that they are about to roll out——

Mr. SMITH. But in addition to the training and educating of farmers, making the commodity exchange more compatible in terms of price, in terms of more offerings where you can lock in some of the costs of more of the inputs that might be added to future trading.

Mr. NEWSOME. Yes, sir, and there are positive things taking place in that very area. One, through the general nature, just because there is greater competition, and I think you are going to see more and more efficiencies in this marketplace, but in terms of smaller contracts, smaller producers' ability to use those types of contracts, we are seeing that now. In fact, as exchanges have colisted, they are continuing to trade open outcry, but then listing the same contract electronically. Typically, those electronic contracts are smaller in size, and it is an attempt to make it easier for producers to utilize those contracts. So there are attempts being made in a number of the specific areas that you just brought up.

Mr. SMITH. Mr. Chairman, thank you.

Mr. MORAN. Thank you, Mr. Smith. Any other questions? Mr. Newsome, you failed to answer my earlier inquiry about whose viewpoint of those financial experts you chose to believe.

Mr. NEWSOME. Let me just say that I am very close to my colleague on the President's Working Group, so I think it would be hard for me to differ with him on this topic.

Mr. MORAN. Chairman Newsome, we thank you very much for your testimony. I also would appreciate to express my willingness to work with you and other commissioners, and Mr. Lukken's participation and attendance here today. We thank you for being here. And this committee meeting is one of a series we will have. The next one is scheduled for June 19, in which we will hear from the industry.

And without objection, the record of today's hearing will remain open for 10 days to receive additional material and supplemental written responses from the witness to any question posed by a member of the panel. This hearing of the Subcommittee on General Farm Commodities and Risk Management is now adjourned.

[Whereupon, at 11:25 a.m., the subcommittee was adjourned.]

[Material submitted for inclusion in the record follows:]

STATEMENT OF JAMES NEWSOME

Thank you, Chairman Moran, and members of the subcommittee. I appreciate your giving me the opportunity to testify on behalf of myself and my fellow commissioners at the Commodity Futures Trading Commission: Commissioner Barbara Holum, who has served impressively at the Commission, taking on numerous responsibilities such as chairing our Global Markets Advisory Committee; Commissioner Walt Lukken, who brought to the Commission a wealth of experience gained on Capitol Hill, including active involvement in the development of the Commodity Futures Modernization Act of 2000 (the CFMA); and Commissioner Sharon Brown-Hruska, who brings the valuable skills of a Ph.D. economist to the Commission. The commodity futures and options markets play a critically important role in the U.S. economy. Today, I would like to describe the CFTC's role in overseeing those markets and how both the markets and our oversight have developed in the 2½ years since passage of the CFMA.

Background: As you know, the Commission was created by Congress in 1974 to oversee the Nation's commodity futures and options markets. The Commission's mission is twofold: to foster transparent, competitive, and financially sound commodity futures markets that operate free from manipulation or distortion, and to protect users of those markets from fraud and other abusive practices. There are important differences between the futures markets and the stock markets. While the stock markets provide a means of capital formation, a way for new and existing businesses to raise funds, the futures markets provide producers, distributors, and users of commodities throughout the economy with the means to manage their exposures to price risk.

Historically, commodity futures were traded primarily on agricultural products. These contracts gave farmers, ranchers, distributors, and users of everything from corn to cattle an efficient and effective set of tools to handle the price volatility often experienced in agricultural markets. Indeed, risk management efforts were seen as so successful in the agricultural sector that this model was eventually adapted for use in other sectors of the economy when, more than two decades ago, contracts were introduced to manage volatility in interest rates, stock market indices, and foreign currency exchange rates. Subsequently, new contracts were developed to provide risk management tools to producers, distributors, and users of energy and metal commodities.

These non-agricultural contracts, following the tradition of success seen in the agricultural futures markets, enjoyed rapid growth as their benefits were quickly recognized by a wide variety of market participants. And while the agricultural contracts continue to enjoy volume growth and are traded as actively today as ever before, the financial contracts based on interest rates, foreign currencies, and stock market indices have actually outgrown them in trading volume because they are useful to market participants in so many sectors of the economy. Because they have come to serve the risk management needs of businesses in virtually every sector of the economy over the last two decades, the volume of trading in the financial contracts is now almost nine times that in agricultural contracts. While farmers and ranchers continue to use futures contracts to effectively lock in the prices for their crops and livestock months before they come to market, manufacturers now can also use foreign currency contracts to reduce uncertainty over the prices they receive for finished products sold overseas. Mutual fund managers can use stock index contracts to protect against market volatility and effectively put a floor on portfolio losses. And corporations in every sector can use contracts on U.S. Treasury instruments to manage their exposure to interest rate volatility.

Although I have described the primary purpose of futures markets as mechanisms for risk management, it should be noted that many futures markets play another important role in the economy, that of price discovery. That is, businesses and investors that may not be direct participants in a particular futures market may nonetheless refer to the quoted prices of certain futures market transactions as reference points or benchmarks for other types of transactions and decisions. This is particularly important in many agricultural markets where no other means of price discovery exist outside of the quoted futures prices but it is also true in other sectors, including many energy markets.

How the CFTC Performs Its Mission: In seeking to fulfill its mission, the Commission has traditionally focused on issues of integrity. We seek to protect the economic integrity of the futures markets so that they may operate efficiently, free from distortions or price manipulations. We seek to protect the financial integrity of the futures markets so that the insolvency of a single market participant does not become a systemic problem affecting other market participants or financial institutions. We seek to protect the operational integrity of the futures markets so that transactions are executed fairly, so that proper disclosures are made to existing and prospective customers, and so that fraudulent sales practices are not tolerated.

Economic Integrity. The Commission pursues these goals through a multi-pronged approach to market oversight. We seek to protect the economic integrity of the markets against attempts at distortion and manipulation through direct market surveillance and through oversight of the surveillance efforts of the exchanges themselves. The heart of the Commission's direct market surveillance is a large-trader reporting system, under which clearing members of exchanges, commodity brokers (called futures commission merchants' or FCMs), and foreign brokers electronically file daily reports with the Commission. These reports contain the futures and option positions of traders that hold positions above specific reporting levels set by CFTC regulations. Because a trader may carry futures positions through more than one FCM and because a customer may control more than one account, the Commission routinely collects information that enables its surveillance staff to aggregate information across FCMs and for related accounts.

Using these reports, the Commission's surveillance staff closely monitors the futures and options market activity of all traders whose positions are large enough to potentially impact the orderly operation of a market. For contracts that settle through physical delivery, such as those in the agricultural futures complex, staff carefully analyze the potential adequacy of deliverable supplies. In addition, staff monitor futures and cash markets for unusual price relationships among contracts that can provide early indications of a potential problem.

The Commissioners and senior staff are kept apprised of significant market events and potential problems at weekly market surveillance meetings, and on a more frequent basis when needed. (For example, market surveillance staff have continuously monitored conditions in the cattle markets since the recent reports of the Canadian BSE diagnosis, just as they did last year with respect to the rumors of foot-and-mouth disease, which led to a Commission report on the event.) At the weekly market surveillance meetings, surveillance staff brief the Commission on broad economic and financial developments and on specific market developments in futures and options markets of particular concern. If indications of attempted manipulation are found, the Enforcement Division investigates and prosecutes alleged violations of the Commodity Exchange Act (the Act or CEA) or the Commission's regulations. Subject to such actions are all individuals that are (or should be) registered with the Commission, those who engage in trading on any domestic exchange, and those who improperly market commodity futures or option contracts. The Commission has available to it a variety of administrative sanctions against wrongdoers, including revocation or suspension of registration, prohibitions on futures trading, cease and desist orders, civil monetary penalties, and restitution orders. The Commission may seek Federal court injunctions, restraining orders, asset freezes, receiver appointments, and disgorgement orders. If evidence of criminal activity is found, matters may be referred to state authorities or the Justice Department for prosecution of violations of the Commodity Exchange Act (the CEA) and of state and Federal criminal statutes, such as mail fraud, wire fraud, and conspiracy.

Over the years, the Commission has brought numerous enforcement actions and imposed sanctions against firms and individual traders for attempting to manipulate or distort market prices, including the well-publicized cases against those who attempted to manipulate prices in the copper and silver markets some years ago. More recently, the most prominent cases have involved problems in certain energy markets. Last year, we ordered a $5 million civil monetary penalty against two energy companies for false reporting and attempted manipulation. In March, we filed a three-count complaint against a major energy trading company charging manipulation of natural gas prices, operation of an unregistered futures exchange, and the offering of off-exchange agricultural futures. Also in March, the Commission finalized a consent order under which another energy company was penalized $20 million for the reporting of false information to certain energy price reporting indices.

Our Enforcement Division is engaged in other investigations in the energy sector, which may result in further charges being filed. However, I want to make clear that when the Commission brings charges against an entity with regard to illegal futures contracts, as in our Enron case, we approach the issues of whether the CEA applies to, and whether we have jurisdiction over, any particular transaction solely on the basis of the economic substance of the transaction. Thus, where we have brought charges alleging operation of an unregistered futures exchange that involved the trading of contracts that may have been labeled or referred to as, quote, swaps, it is because the economic substance of those transactions was that of a futures contract. Let me assure you, Mr. Chairman, that we are not seeking to expand the scope of our jurisdiction over other transactions, such as the true swaps and forwards that Congress has determined—appropriately so, in my opinion—to exclude under the CEA. In the case of over-the-counter (OTC) swaps, for example, such an exclusion was expressly provided by the CFMA following recommendations from the President's Working Group on Financial Markets, and I believe that this brought much-needed legal certainty for counterparties in this important sector of the risk management market.

I wanted to emphasize that point because the Commission believes that legal certainty and regulatory clarity are critically important for the efficient and reliable operation of markets generally, but perhaps particularly important for many derivatives markets. If the enforceability of contracts is in doubt among counterparties or if regulations or regulatory enforcement policies are unclear, then rational market participants must factor that uncertainty into their decisions and this, in turn, can result in unnecessary added costs, missed opportunities, inefficient results, and misallocated resources. The CFMA provided much-needed legal certainty in a variety of areas, including the OTC markets. The importance of OTC risk management markets should not be overlooked nor should the fact that effective control mechanisms already at work within those markets themselves have made defaults and other problems there very rare.

The Commission's aggressive enforcement actions in the energy sector reflect an approach to market oversight that emphasizes, as the proper deterrent to wrongdoing, tough enforcement actions against those who would try to operate outside the established rules. Simply issuing more numerous or more prescriptive regulations that could adversely affect legitimate activities is not the correct, or even an effective, deterrent. The established rules should lay out a basic legal framework without being overly prescriptive or unnecessarily burdensome and they should permit sufficient flexibility for market participants to innovate and compete in legitimate business endeavors, a process that can bring to the marketplace greater liquidity, more useful risk management tools, more efficient pricing, and enhanced customer service. But once established, the rules must be enforced, and enforced firmly.

The Commission has been successful in its recent enforcement efforts. For example, one of the many helpful clarifications provided by Congress through the CFMA was legal certainty for the Commission in the area of retail foreign exchange fraud. Our Enforcement Division has risen to the challenge and in just over two years has conducted numerous investigations and initiated almost three dozen formal actions, making a big dent in this type of abuse against futures market participants, particularly individuals.

Financial Integrity. In protecting the financial integrity of the futures markets, the Commission's two main priorities are to avoid disruptions to the system for clearing and settling contractual obligations and to protect the funds that customers entrust to FCMs. Clearinghouses and FCMs are the backbone of the exchange system: together, they protect against the financial difficulties of one trader from becoming a systemic problem for other traders or the market as a whole. The Commission works with the exchanges and the National Futures Association (the NFA) to closely monitor the financial condition of FCMs. The Commission, the exchanges, and the NFA receive various monthly, quarterly, and annual financial reports from FCMs. The exchanges and the NFA also conduct annual audits and daily financial surveillance of their respective member FCMs. Part of this financial surveillance involves looking at each FCMs exposure to potential losses from large customer positions that it may be carrying. One of the ways in which such positions are tracked is through the large trader reporting system. As an oversight regulator, the Commission primarily reviews the audit and financial surveillance work of the exchanges and the NFA but it also monitors the health of FCMs directly, as necessary and appropriate. The Commission also reviews clearinghouse procedures for monitoring risks, ensuring the adequacy of margin and capital requirements, and protecting customer funds.

As with attempts at manipulation, the Commission's Enforcement Division investigates and prosecutes FCMs that are alleged to have violated financial and capitalization requirements or to have committed other supervisory or compliance failures in connection with the handling of customer business. Such cases can result in substantial remedial changes in the supervisory structures and systems of FCMs and can influence the way particular firms conduct business. This is an important part of the responsibility of the Commission to ensure that sound practices are followed by FCMs.Operational Integrity

Protecting the operational integrity of the futures markets is also accomplished through various efforts by Commission staff. Commission rules provide for appropriate disclosure and customer account reporting, as well as fair sales and trading practices by registrants. The Commission also seeks to encourage appropriate sales practices by screening the fitness of industry professionals and by requiring proper supervision of such persons, and ensuring that adequate proficiency testing and continuing education take place. Extensive recordkeeping of all futures transactions is also required. To ensure compliance with these various requirements, the Commission directly monitors compliance but also supervises the work of exchanges and the NFA in enforcing the relevant requirements.Just as with the Commission's efforts to protect the economic and financial integrity of the futures markets, the Division of Enforcement also plays an important role in deterring behavior that could compromise the operational integrity of the markets. Enforcement investigates a variety of trade and sales practice abuses that affect customers. For example, the Commission brings actions alleging unlawful trade allocations, trading ahead of customer orders, misappropriating customer trades, and certain non-competitive trading. The Commission also takes actions against unscrupulous commodity professionals who engage in a wide variety of fraudulent sales practices against the public.

In addition to our individual efforts, the CFTC also works cooperatively with other financial regulators. As Chairman of the CFTC, I sit on the President's Corporate Fraud Task Force. I am also a member of the President's Working Group on Financial Markets with Secretary Snow, Chairman Greenspan, and Chairman Donaldson. My experience has been that the coordinated approach has many advantages, especially in markets that cross regulatory jurisdictions and with respect to issues that can affect multiple markets in the financial system.

Changes at the CFTC since the CFMA: After passage of the CFMA, we reorganized and modernized the structure of the CFTC to make the most effective use of our resources in overseeing these important and dynamic markets. Our Division of Market Oversight, which includes primarily economists, conducts ongoing market surveillance and other key functions, including reviews of contracts and exchange rules. Our other major regulatory unit is the Division of Clearing and Intermediary Oversight, which includes auditors and other staff who monitor the financial and operational integrity of the clearinghouses and their clearing members to ensure that customer funds are protected and that safeguards are in place to prevent individualized financial problems from being transmitted through the system. This division also is responsible for the registration of FCMs, pools operators, and trading advisors. Supplementing the expertise of these two divisions is our Chief Economist's Office, which provides key analysis to the other divisions and to the Commission, as well as our Office of General Counsel, which provides legal expertise to the Commission and handles such matters as our appellate cases. As noted above, a very effective Division of Enforcement investigates and brings cases against those who attempt to defraud customers, distort or manipulate prices, or otherwise violate the CEA and the Commission's rules.

The Commission is looking at how we approach all of our oversight responsibilities with an eye toward making changes wherever we can increase our effectiveness and make better use of taxpayer resources, including such things as risk-based audits and developing, pursuant to Congressional direction through the CFMA, an oversight framework for futures clearinghouses. With the audits, the move from a strictly compliance-based approach to a risk-based approach can better focus the resources of both the Commission and the self-regulatory organizations for maximum effectiveness. We recently initiated the first such examinations and the process appears to be on the right track.

Passage of the CFMA 2½ years ago initiated a period of intense effort at the Commission. Our first task, guided by schedules established within the legislation, was to modernize the rules affecting trading facilities, both traditional and the new electronic commercial markets now permitted by the CFMA. Despite the unexpected challenges the industry and the Commission faced following the September 11 attacks, those rule modernizations have been successfully accomplished. Working with the Securities and Exchange Commission, the CFTC was also able to put into place the rules and other mechanisms to allow the launch of trading in domestic security futures.

Now the Commission is well underway with efforts to modernize the rules affecting clearinghouses, futures commission merchants, pooled investment managers, and other intermediaries in the futures markets. Through hearings, studies, and roundtables, the Commission has, as directed by Congress, undertaken a concerted examination of the rules currently imposed on intermediaries and we have identified a number of areas where key improvements can be made. These range from providing financial institutions that are primarily overseen by another regulator (such as banks, insurance companies, and mutual funds) with an opportunity to use the risk management tools offered in the futures markets without subjecting themselves to unnecessary duplicative regulation, to providing appropriate registration relief to pooled investment vehicles that restrict participation to sufficiently well sophisticated persons, to affording FCMs with greater operational flexibility so that they can provide their customers with more efficient trade executions. We have proposed a great number of rule modernizations in the Federal Register, received largely supportive and always insightful comments on these proposals, and implemented final rules in a number of areas. We are also well underway with efforts to design an effective oversight framework for clearinghouses which, as discussed below, occupy a new place in the regulatory landscape since passage of the CFMA.

Changes in the Marketplace since the CFMA: The CFMA opened the door for great change in the markets as well as at the CFTC. The U.S. commodity futures and options markets continue to grow rapidly. Total volume rose by more than 33 percent from 2000 to 2001, and again by more than a third from 2001 to 2002, as increasing numbers of companies and investors avail themselves of the risk management tools offered by these markets. Financial contracts represent the largest portion of the market and continue to grow in volume. Of the ten most widely traded contracts, which together represent more than 80% of U.S. futures volume, seven are financial contracts (based on Eurodollars, Treasury instruments, the S&P 500, and the Nasdaq 100). The other three top-ten contracts are crude oil, natural gas, and corn. (Soybeans are close behind corn in the eleventh spot.) While the traditional U.S. futures exchanges are enjoying record volumes, not all the growth is taking place there. Newly designated contract markets (DCMs) that have been approved by the Commission since passage of the CFMA are achieving significant trading volumes with new products and platforms.

Security Futures. Perhaps one of the most visible categories of new products is, of course, the security futures category. Futures based on individual stocks or on narrow stock indices were prohibited from trading for almost twenty years prior to the CFMA. Three brand new exchanges have been created to host trading in these new contracts, offering equity investors and portfolio managers of all kinds access to useful new risk management tools. Security futures are treated as both futures and securities under the CFMA and, accordingly, both the CFTC and the SEC share oversight responsibility for their trading under a primary regulator and notice regulator regime intended to avoid duplicative or overly burdensome requirements on market participants. Some work still remains to be done, but we are optimistic that the two agencies can continue to cooperate to fully accomplish the purposes of the CFMA in this area.

I have been asked for my views on the growth thus far in trading of security futures. Prior to last year's launch, I refrained from making forecasts of how popular these products would be because I felt that it was my role as a regulator to make sure that success would not be decided by regulators but by market participants in a marketplace made as free as possible from unnecessary, duplicative, or unduly restrictive regulations. Having said that, I would point out that other products in our markets have faced some initial skepticism and yet turned out to be quite successful. While I recognize that it may not be exactly an apples-to-apples comparison, I would note, for example, that average monthly volumes in the security futures offered thus far on Microsoft common stock have exceeded the volumes in the now hugely successful Treasury bond, Eurodollar, and crude oil contracts during corresponding periods after their introduction.

Other Changes. Strong trading growth and security futures are not the only changes that have been occurring recently. Other key trends in the futures markets include the continued migration of trading activity from open-outcry trading on the exchange floors to all-electronic trading from widely dispersed geographic locations, the transition from purely member-owned exchanges to publicly-held trading facilities, continued globalization of all financial markets, and, of particular note since passage of the CFMA, the decoupling of the trading activities hosted by exchanges from the clearance and settlement functions performed by clearinghouses. The CFMA made express provision for this last transformation and we are already starting to see activity in this area, with recent press announcements of new relationships among exchanges and clearinghouses that would have been hard to imagine only several years ago.

In fact, while the Commission has designated four new contract markets since passage of the CFMA, it is has accepted the registration of five additional derivatives clearing organizations, several of which were existing clearinghouses serving other financial market sectors outside of futures but several of which are new organizations not previously affiliated with any particular trading facility. The Commission has received expressions of interest or applications from numerous other trading facilities and clearing organizations and foresees that its oversight responsibilities in both areas will only increase as time goes on.

Not only does the Commission foresee more work ahead as volumes increase and as market participants are presented with greater choice in risk management products and trading platforms, and as clearing and settlement functions evolve, but the work is changing in ways that present new and exciting challenges for the Commissioners and the staff. Under the CFMA's principles-based approach, which we have commended the Congress for adopting to replace an outdated regime of prescriptive and often obsolete regulations, the Commission works with exchanges, clearinghouses, and others who now have the flexibility to satisfy the fundamental objectives of the CEA in alternative ways, some traditional but some very new and unique. Gone is the era of cookie-cutter applications and Commission approvals that dictate the same approach for every institution. While I believe the new era will be one in which market users benefit greatly from innovative uses of technology, better customer service, greater liquidity, and more efficient transactions, I also believe that the Commission and its staff will have to work harder than ever to fulfill its important public mission.

I am excited by the remarkable changes we have seen in just the short time since enactment of the Commodity Futures Modernization Act. I firmly believe that it was the right legislation to pass at the right time and that its principles-based approach has already proven to be a workable and effective means of overseeing markets that play a crucial role in the U.S. economy. The Commission stands ready to work with this Subcommittee, the Congress, other regulators, and market participants to ensure that our regulatory structure keeps up with developments in the marketplace and continues to make good sense. Thank you for the invitation to appear before your subcommittee. I will be happy to answer any questions you may have.

COMMODITY FUTURES MODERNIZATION ACT

THURSDAY, JUNE 19, 2003

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON GENERAL FARM COMMODITIES
AND RISK MANAGEMENT
COMMITTEE ON AGRICULTURE,
Washington, DC.

The subcommittee met, pursuant to call, at 10:00 a.m., in room 1300 of the Longworth House Office Building, Hon. Jerry Moran (chairman of the subcommittee) presiding.

Present: Representatives Smith, Everett, Lucas, Jenkins, Burns, Peterson, Alexander, Pomeroy, Etheridge, Larsen, Davis, and Stenholm [ex officio].

Staff present: Jon Hixson, Dave Ebersole, Ryan Weston, Callista Gingrich, clerk; Kellie Rogers, and John Riley.

OPENING STATEMENT OF HON. JERRY MORAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF KANSAS

Mr. MORAN. The hearing of the Subcommittee on General Farm Commodities and Risk Management will come to order.

We are here to review the Commodity Futures Modernization Act, and I am delighted to welcome the witnesses to the panel today.

This is the second of a series of hearings that we are taking, as a subcommittee, to look at the Commodity Futures Modernization Act. This subcommittee has spent a lot of time over the last several years looking at these issues of reauthorization. We have heard lots of stories, concerns, challenges, and I think it is appropriate for this subcommittee to take a little time to see the results of that legislative effort to learn from the industry's perspective as to the good things that may have been accomplished and the errors that may have occurred.

Several weeks ago, we heard from Chairman Newsome of the CFTC, and he provided a regulatory perspective as to the Act. I hope today that we will hear about implementation of CFMA so that we can learn the appropriate level of regulation and regulatory relief, determine whether we were successful in our attempt to develop the appropriate level of that regulation and to allow U.S. markets to compete effectively while protecting market integrity for all participants.

We also have a relatively new number of members of this subcommittee to whom these issues are relatively new, and we look forward to the education that this distinguished panel of witnesses will be able to provide our subcommittee.

I now turn to the distinguished gentleman from Minnesota, Mr. Peterson.

OPENING STATEMENT OF HON. COLLIN C. PETERSON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MINNESOTA

Mr. PETERSON. Thank you, Mr. Chairman, and thank you for holding this hearing.

It certainly is time for us to examine the results of CFMA, which has been law for about 2½ years now. As we will hear today in the testimony, since the passage of CFMA, this has been a successful piece of legislation. I want to join you, Mr. Chairman, in welcoming our distinguished guests, and I look forward to hearing their testimony.

Mr. MORAN. Thank you very much Mr. Peterson.

Other statements for the record will be included at this time.

[The prepared statement of Mr. Smith follows:]

PREPARED STATEMENT OF HON. NICK SMITH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Thank you Mr. Chairman for holding this informative hearing to review the Commodity Futures Modernization Act. The futures trading industry is a vital and ever-expanding part of our Nation's economy. For many years the futures industry has been important to the agricultural industry as a mechanism of price discovery and a risk management tool for farmers. The passage of the Commodity Futures Modernization Act was a significant landmark for the derivatives industry. As we will hear today and at previous hearings, the futures industry has seen record-setting growth in the number and values of contracts traded over the several years.

Although the Commodity Futures Modernization Act has primarily influenced the non-agricultural sector of the futures industry, as a fanner and member of the Agriculture Committee I am particularly interested in agricultural trading and hedging on the: futures market. Commodity futures trading laws in the U S. started primarily as a service to the agriculture industry as futures markets developed for various farm commodities. Over the years the futures industry has rapidly expanded into other markets.

As a result, agriculture has become a much smaller part of the overall total exchange. In 2002, agricultural commodities accounted for only about 5 percent of the total futures contract volume actively traded in the U.S. With the rapid expansion of the futures industry into other markets, agriculture sometimes does not get attention in ways that might better serve the average fanner to help them buy and sell futures contracts so that they may better manage their risk by utilizing futures marketing.

I would suggest, Mr. Chainnan, that maybe Congress, the Commodity Futures Trading Commission, and the futures industry should be looking at different ways that we can encourage farm producers to better manage their own risks by utilizing futures contracts directly through their local elevator. Hedging on the futures marketmanage their own risks and we should continue to look for innovative means by which we can facilitate utilization of the futures market both in the commodities farmers sell and the products farmers buy. Thank you.

Mr. MORAN. We will begin the testimony with Mr. Carey, who tells me that this is his first appearance before a subcommittee or committee of Congress. Mr. Carey, this is a very intimidating group, but we welcome you and we assume that someone from Chicago can handle us just fine.

STATEMENT OF CHARLES P. CAREY, CHAIRMAN, CHICAGO BOARD OF TRADE, CHICAGO, IL

Mr. CAREY. Mr. Chairman, members of the subcommittee, my name is Charlie Carey, and I am chairman of the Chicago Board of Trade. I am joined this morning by Bernie Dan, our President and CEO.

It is an honor to appear here today. Over 100 years ago, my grandfather came to the Chicago Board of Trade. Both my grandfather and my uncle served as a chairman, so I am a third-generation chairman. And I am very proud of that tradition.

Mr. Chairman, thank you for the opportunity to address current issues facing our exchange. Your interest and leadership are very much appreciated.

First, I thought I should give you a quick update on our business since the Commodity Futures Modernization Act was enacted in 2000. We are doing well, and growing stronger. In each of the last 2 years, we have achieved record trading volumes. This year, our volume is up again, running 37 percent above last year's pace. Overall, these figures reflect the confidence our customers have in both our pit and electronic trading platforms.

Despite our past and current success, we know our competitive challenges are ever increasing. Before I describe our response to those challenges, I want to share with you a few observations about the CFMA. The Board of Trade strongly supported passage of that legislation. Modernizing futures regulation, providing legal certainty for OTC derivatives, and opening the door to single stock futures trading were sound policy goals we were pleased to endorse.

Since enactment of the CFMA, futures regulation has worked well. In large part, that success is due to the efforts of the Commodity Futures Trading Commission under the strong leadership of Chairman Jim Newsome. I believe Chairman Newsome has the respect of everyone in the futures industry for his fair judgment and constructive insight.

Competition seems to be the main theme of the industry debate today. As I am known for being blunt, let me say this. Those who would tell you that U.S. futures exchanges are monopolies and face no competition are completely out of touch with reality. There is more competition today than ever before.

Twice in the past 5 years, new exchanges were created to compete directly with us. What happened? We competed, and we prevailed. Why were we successful? In my opinion, we have the most cost-effective, reliable, fair, transparent, and safe markets available. Our members provide the essential ingredient of market liquidity that makes spreads tight, order execution dependable, and prices reflective of true economic conditions.

Despite our record, I know that existing and new competitors will challenge us in the future. This year, the Chicago Board of Trade has made two decisions that demonstrate our willingness to compete. In January, the Board of Trade chose to replace our current electronic trading platform with LIFFE CONNECT. That selection was based on one overriding factor: we wanted to offer the best trading platform for our customers and members. LIFFE CONNECT is robust, adaptable, and will help us grow our markets.

Second, on April 16, the Board of Trade announced a truly historic clearing link with the Chicago Mercantile Exchange. Again, we changed our clearing platform, because doing so was best for our customers.

The link is a win-win proposition. It will result in cost savings while strengthening financial integrity. Through these two decisions, we have improved our markets on two key fronts. Together, the LIFFE CONNECT platform and the Common Clearing Link will fortify the Board of Trade's overall business objectives by building upon our core values of transparency, liquidity, flexibility, and market integrity.

We know new exchanges and new competition will arise in the years to come. In fact, the media has reported that a major foreign exchange intends to open a U.S. futures exchange next year. The CEO of that exchange's parent recently hailed its track record for "cross-border stealing of liquidity." That plan would be unprecedented.

The futures regulatory system, especially after CFMA, is built on self-regulation. Exchanges are called upon to protect market integrity and other recognized public interest. Whether a foreign-owned U.S. exchange could adequately discharge those responsibilities in all circumstances raises questions that have not had to be considered previously. In other areas of our economy, foreign ownership considerations have resulted in the adoption of special regulatory rules. To the extent the rumored business plans of foreign exchanges present similar concerns, we are sure the CFTC will consider those issues carefully and fully.

This is an exciting time for the futures industry. Exchange trading is in great demand worldwide. More futures and options contracts are traded on U.S. exchanges than anywhere else in the world. The Board of Trade is proud to play a leading role in helping to create this national industry.

Thank you for the opportunity to appear before you today.

[The prepared statement of Mr. Carey appears at the conclusion of the hearing.]

Mr. MORAN. Mr. Carey, thank you very much for your testimony.

Mr. Terrence A. Duffy is the chairman of the Chicago Mercantile Exchange. Mr. Duffy, we welcome you back to our committee.

STATEMENT OF TERRENCE A. DUFFY, CHAIRMAN, CHICAGO MERCANTILE EXCHANGE, CHICAGO, IL

Mr. DUFFY. Well, thank you very much, Chairman Moran and members of the subcommittee.

I appreciate the opportunity to testify on behalf of the Chicago Mercantile Exchange. I have served as chairman of the CME since April 2002. This has been a time of growth and change for our institution. On December 6, 2002, we completed our initial public offering and became the first publicly traded financial exchange in the United States.

This has also been a very challenging political and economic period for our country and the world. In these uncertain economic times, the Chicago Mercantile Exchange is essential in helping institutions, corporations, and individuals effectively manage their financial risk.

In the judgment of the CME, the Commodity Futures Modernization Act of 2000, or the CFMA, represents successful landmark legislation. Our futures markets are stronger and more vibrant today as the direct result of Congress's enactment of the CFMA, and equally important, the CFTC's judicious and deliberate implementation of those reforms.

This can be attributed to the decisive leadership of Chairman Jim Newsome. Under his skillful leadership, innovation has been encouraged and made less costly and more rewarding. The time between conception of a new product or trading system and its implementation has gone from years to days. Today, the vast majority of CME's investment in innovation is for improvement and testing rather than paperwork and bureaucratic review.

I want to highlight some of our many achievements under the CFMA regime and indicate some important initiatives now underway at the CME. During June, our average daily volume thus far has increased to 3 million contracts per day, a healthy 43 percent increase from 2002 average daily volume. Our open interest reached an all-time record high of 25 million contracts, representing a notional value of $18 trillion. Volume on our GLOBEX electronic trading platform has gone from hundreds of contracts per day to more than 1 million contracts per day, while the open outcry trading floor continues to serve its core customers who prefer to trade in that venue.

The CME's E-mini S&P 500 futures contract reached a new record of 116 million contracts in 2002, an increase of 194 percent from the prior year. The E-mini S&P remains the fastest growing product in the history of the Chicago Mercantile Exchange.

The latest major development at the CME, as just mentioned, is the recently signed definitive agreement between the Chicago Board of Trade and the Chicago Mercantile Exchange to establish the CME/CBOT Common Clearing Link. Under this agreement, the CME will provide clearing services for all Chicago Board of Trade products beginning on January 2, 2004. We expect that the CFTC's regulatory review will be efficient and expeditious, free of time-consuming processes that would have been standard prior to the CFMA. Naturally, we also expect the CFTC to grant all regulatory approvals in order to maintain our targeted rollout date of January 2, 2004.

By clearing CME and CBOT products through our clearinghouse, we will offer extended portfolio margining, in other words, we will recognize the positions held at both exchanges and reduce performance bonds as appropriate. This exemplifies our efforts to provide value to our customers and shareholders at the same time. This new clearing agreement also signals CME's ability to provide transaction processing services to third parties.

Our new publicly traded status will help us achieve the key elements of our long-term business strategy. I want to dispel a myth about publicly owned exchanges: some regulators have speculated that a for-profit business model may pressure exchanges to reduce spending on self-regulation. We strongly disagree. While we were a mutual membership-owned not-for-profit corporation, we never wavered from our commitment of funding our regulatory systems, programs, operations, and staffing levels. Despite significant budget pressures, we never reduced our commitments to this important area because we understood its importance to our overall success.

Rather than detracting from our ability as an effective self-regulator, the CME's incentives and capability to maintain an effective program of self-regulation have been enhanced by its reorganization as a for-profit company. The regulatory staff's independence and empowerment have been cemented by this new corporate structure. The CME is subject to the disclosure and reporting requirements imposed by the Securities Act of 1933 and the Securities and Exchange Commission regulations.

CME's ownership base has been expanded to include institutional investors. Professional security analysts, who are unaffiliated with the CME and/or its bankers, follow every action of the company. Any failure to maintain and effectively implement prudent regulatory programs will cause these analysts and shareholders to adopt a negative view of our performance, and subsequently, our stock price could decline. The scrutiny of these shareholders and analysts ensure that we have sufficient inducement to maintain the effective regulatory programs that are so crucial to our brand name and our success.

The CFMA broke new and important ground in authorizing the trading of single stock futures. The discussions between the CFTC and the SEC with regard to regulatory regime pertaining to single stock futures have taken a considerable amount of time, and we understand that the agencies believe they are coming to the end of that process.

Nonetheless, we want to bring the subcommittee's attention what we consider to be a very important problem we have experienced in the initial efforts to bring single stock futures products to market. Our experience, as a notice registered security exchange and our view of the regulatory burdens to which our joint venture, OneChicago, has been subjected, lead us to the question of whether the CFMA provisions respecting joint jurisdiction over exchanges that trade security futures products are being misapplied by the SEC. After a protracted effort to list security features products, the CME withdrew its submission rather than subjecting itself to confusing and costly dual regulation.

The details of this story are included in my written testimony. In brief, Congress granted the CFTC and SEC jurisdiction over exchanges that list and trade security futures products, but clearly determined that the exchange's principle registration status should decide which agency should take the lead. In the case of the CME and OneChicago, the CFTC is the primary regulator. The SEC has asserted the authority that effectively puts it on a par with the CFTC and creates a system of active dual regulation contrary to the clear intent of Congress. If unaddressed, this problem threatens to undermine Congress's intent that dually regulated exchanges not be burdened by duplicate regulation.

While we applaud the many improvements made by the CFMA's rewrite to the Shad/Johnson Accord and other major parts of the CEA, there is no one area in which this was a step backwards, or at least a step sideways. That is the area of index futures on non-equity securities. The rule distinguishes between broad-based and narrow-based security indexes apply to all securities. But the rule was drafted without clear consideration of the significant differences in the trading volume and trading velocity between equities and fixed income securities. The U.S. fixed income securities are not typically traded on organized exchanges, and their trading volume is significantly smaller than that of stock volume. The CFMA does not distinguish between the two different classes of securities with the result that the same criteria are applied in determining which cash instruments can be the basis for futures contracts.

We urge Congress and the CFTC and the SEC to use all of their available means to remedy this situation.

I want to talk just for a minute about the COOL, Country of Origin Labeling. It is part of the 2002 farm bill. It will require, among other things, all meat sold at retail grocery stores, to carry a label showing the country or countries in which the animal was born, raised, and processed. This labeling requirement becomes effective September 30, 2004, and retailers are subject to a $10,000 fine for each violation.

While we are aware of the ongoing controversy among affected elements of the industry as to whether Congress should revisit COOL, perhaps delaying or modifying the provision, or even repealing it, under current circumstances, CME will need to bring our live cattle contract into compliance with COOL. We are experiencing a number of serious timing and design issues for 2004 cattle complex contracts, which I have detailed in my written testimony.

We are working with the USDA and the industry to find solutions, but the CFTC has signaled that it understands the problems and will work with us to find a solution.

The CME strongly supported the CFMA and its philosophy of expanding our opportunities to compete, while simultaneously challenging us by permitting new market structures and easing barriers to entry of new competition. As much deliberation as Congress gave the CFMA over the several years preceding its enactment, no consideration was given to the question of foreign control of U.S.-based derivative exchanges. CME welcomes fair competition from all sources but is concerned that the CFMA's lack of specific focus on foreign ownership may be taken as a signal that significant issues arising out of such control are irrelevant to the statutory standards for designation of a contract market.

The enactment of the CFMA has brought a wide variety of constructive and beneficial reforms to the regulation of America's derivative markets. The Nation and the market participants, including CME, are better off as a result of the CFMA. The CFTC has administered the CFMA responsibly, but new challenges remain to be addressed if the full promise of the CFMA is to be realized.

We look forward to continuing to work with Congress and the CFTC in finding appropriate answers to these challenges.

Thank you.

[The prepared statement of Mr. Duffy appears at the conclusion of the hearing.]

Mr. MORAN. Mr. Duffy, thank you very much.

Our next panelist is Mr. Neal L. Wolkoff, who is the executive vice president and chief operating officer of the New York Mercantile Exchange. Welcome, Mr. Wolkoff.

STATEMENT OF NEAL L. WOLKOFF, EXECUTIVE VICE PRESIDENT AND CHIEF OPERATING OFFICER, NEW YORK MERCANTILE EXCHANGE, NEW YORK, NY

Mr. WOLKOFF. Thank you, Mr. Chairman, members of the committee.

The New York Mercantile Exchange is the leading exchange in the world for the trading and clearing of energy futures and precious metals contracts. On behalf of the Exchange, the Board of Directors, the members, and the staff of the Exchange, I appreciate the opportunity to be here to testify about the Commodity Futures Modernization Act of 2000.

To lead off, NYMEX commends Congress for its vision and its leadership in the passage of the CFMA. I have submitted written testimony with a great deal of details, and I will just summarize that for the committee, but the bottom line is that under the regime of the CFMA, NYMEX has thrived.

To date, NYMEX has not taken full advantage of the different regulatory tiers made available by the CFMA. We have remained in the highest level of regulation, the contract markets tier. However, the incorporation by the CFMA of principles-based regulation, where there are a series of core principles for both the trading and the clearing of futures and options products, has given us much greater flexibility with respect to how we may comply with the general standards of the Act. We believe that this has occurred without any loss in integrity or regulatory supervision on behalf of the Government.

We especially appreciate being able to submit new products and rules to the CFTC on a self-certification basis and then make those rules effective in a relatively immediate way. Streamlining the product submission process has benefited our market users and has allowed us to be much more competitive with exchanges operating worldwide than we previously were.

Credit must be given to the CFTC, to Chairman Newsome, and to the other Commissioners in how sincerely they have taken the spirit of the CFMA to heart in assuring that their regulation is substantive and not bureaucratic.

We believe that the developments in the energy cash markets over the last year or two have reemphasized the importance of having markets that are transparent, reliable, and publicly accountable. And we have seen clear evidence that customers, as shown by record volume levels last year at NYMEX, agree with us. The overwhelming majority of our market users are commercial or other institutional companies seeking to use the Exchange's markets to make their price discovery or hedging needs in energy and metals products. Notwithstanding their status, however, as sophisticated, knowledgeable, commercial entities, most of our market participants have expressed a strong desire to conduct their business in a fully and well-regulated marketplace where the rules are applied consistently and assertively and prices are transparent.

Under the CFMA, another benefit that the Exchange has realized is the separation of the trading function from the clearing function. In addition to listing a number of new products for trading, NYMEX has also been able to serve the energy market users who are in such need of credit mitigation in their counterparty relationships in the form of providing clearing services for transactions executed originally off Exchange and then submitted to NYMEX for clearing as fully regulated futures contracts. There is still a liquidity crunch in OTC energy markets. Among the largest merchants, there has been a market capitalization loss of almost $300 billion since the Enron bankruptcy. And the need for transactional oversight and credit mitigation is extreme in order to keep liquidity in this business, all of which goes ultimately to the benefit of the consumer.

As a final point, a year or so ago, we suggested, and I will say I suggested, that it would be useful to clarify the scope of the CFTC's anti-fraud and anti-manipulation over certain products and markets. And we further suggested a need for greater transparency and public accountability for certain markets within the CFTC's jurisdiction, particularly where such markets served a price discovery function.

While NYMEX is generally supportive still of these policy goals, we also take note of the extensive number of investigations now underway by the CFTC. Accordingly, we agree with the chairman that the best public policy approach would be to defer any congressional consideration of amendments to the Commodity Exchange Act, or the CFMA, until the CFTC has had an opportunity to complete its ongoing matters. At that time, a clearer picture should be available as to whether there is a need for legislative change.

There is a real basis for believing in any event that the ordinary operation of free markets, alongside the existing regulatory and prosecutorial functions of government, may well bring about the number of benefits and changes to the marketplace without an immediate need for change to the CFMA.

Gentlemen, I believe my time is up. I will be happy to answer any questions. And thank you very much for hearing me.

[The prepared statement of Mr. Wolkoff appears at the conclusion of the hearing.]

Mr. MORAN. Mr. Wolkoff, thank you very much.

We now welcome Mr. John M. Damgard, who is president of Futures Industry Association. Welcome back, Mr. Damgard.

STATEMENT OF JOHN M. DAMGARD, PRESIDENT, FUTURES INDUSTRY ASSOCIATION, WASHINGTON DC

Mr. DAMGARD. Mr. Chairman, members of the subcommittee, on behalf of the Futures Industry Association, I appreciate the opportunity to appear before you today to discuss the impact of the Commodity Futures Modernization Act of 2000, on the derivatives industry generally, and more specifically, on the CFTC.

We want to congratulate you, Mr. Chairman, for scheduling these oversight hearings. The CFMA signaled a radical new approach to the regulation of the derivatives markets, by which Congress authorized the Commission to develop a regulatory program for markets that would be "tailored to match the degree and manner of regulation to the varying nature of the products traded thereon, and to the sophistication of the customer." It is important, therefore, that the subcommittee examine from time to time the progress that the Commission is making in implementing this program.

The CFMA, of course, had other equally important goals. Among them, the CFMA removed the 20-year prohibition on futures on individual securities and narrow-based indexes and, in another radical departure, provided for the joint regulation of these products by the Commission and the Securities and Exchange Commission. In addition, this legislation sought to assure legal certainty for over-the-counter derivative instruments.

We want to join in the praise and congratulate Chairman Newsome, the other members of the Commission, and the Commission staff for their efforts over the past 2½ years in developing the regulations necessary to implement the myriad provisions of the CFMA. It placed enormous demands on the Commission, and the Commission has met every challenge. In the area of regulatory relief for intermediaries, in particular, the Commission has undertaken steps that should alleviate a number of the regulatory burdens that intermediaries have faced.

The fate of the FIA and its members and the U.S. derivatives exchanges are inextricably intertwined. FIA estimates that our members effect more than 90 percent of all customer transactions executed on U.S. contract markets. Our 20 largest members, all US FCMs, bring customer business to U.S. exchanges from four corners of the world. Among them, these FCMs hold customer segregated funds, that is funds held solely for trading on U.S. futures exchanges, in excess of $51 billion, approximately 90 percent of all customer segregated funds held by US FCMs. We, therefore, share in the Exchange's pride and the tremendous growth these markets continue to experience. The Exchange's success is our success.

Our belief in strong, competitive exchange markets led us to work closely with Congress, the Commission, and related industry groups, including the exchanges and associations represented at this table today. We were, and remain, convinced that an underlying purpose of the CFMA was to promote responsible innovation and fair competition among boards of trade, other markets, and market participants. And it could not be achieved unless the prescriptive regulatory structure that had been so restrictive in the Exchange's conduct was replaced.

Subject to the Commission's vigilant oversight, the core principles set forth in the CFMA should be more than adequate to assure that the purposes of this Act are met. A critical core principle of the CFMA is the requirement that "unless appropriate to achieve the purposes of the Act", designated contract markets and derivatives clearing organizations must "avoid adopting any rule or taking any action that results in an unreasonable restraint of trade, or imposing any material anti-competitive burden on trading." Therefore, if any action of an exchange or clearing organization appears to violate that requirement, the Commission would be authorized to act.

We believe Congress shared our enthusiasm for competitive markets and fully anticipated that the regulatory reform it endorsed through the CFMA would encourage new entrants to apply for designation with the Commission as contract markets or clearing organizations. These entities would compete among themselves and with existing exchanges for customer business based on products, quality of execution, and cost. Although the vigorous rivalry that we had hoped for and that we believe Congress anticipated in enacting the CFMA has not materialized. We are pleased that a number of entities see an opportunity in the U.S. that was not available before.

The futures industry has long recognized the benefits of common clearing in reducing costs to FCMs and their customers. A common clearing entity is a single clearing organization that would clear and guarantee contracts traded on all U.S. futures exchanges. A common clearing organization would: reduce systemic risk by concentrating position and margin information in a single clearing organization; two, result in a substantial reduction in margin requirements; and three, reduce the security deposit, guarantee fund, and share ownership requirements of clearing member FCMs.

There are currently seven active futures clearing organizations in the United States. In the absence of an agreement on Common Clearing Initiative that failed several years ago, FIA and its members began to explore alternatives that would provide, to the extent practical, many of the same economic and risk benefit efficiencies. For a period last year, we were encouraging the adoption of a program that we call directed clearing. Directed clearing would have allowed an FCM to choose the clearing organization at which its contracts could be cleared. In this manner, the clearing firm would be able to take full advantage of the benefits of portfolio margining across all U.S. markets. An advantage of directed clearing would be that it would let the market decide based on quality of service, breadth of services and costs, which clearing organizations were best able to meet users' needs. This approach reflected our firm belief that the market, and not the Government, should determine which clearing organizations and which exchanges and which FCMs, for that matter, would succeed and which ones would fail.

More recently, the FIA has begun to examine another proposal that would allow FCMs and their customers to make more efficient use of their capital through portfolio margining across all markets. Through its competitive clearing committee, FIA is reviewing the feasibility of establishing what we call a centralized capital facility. It would consolidate position information and centralize performance collateral across clearing organizations and could be an effective means of providing portfolio margining across all markets. We look forward to the opportunity of discussing this proposal with the exchanges and clearing organizations at the appropriate time.

We can not leave the topic of clearing without acknowledging the Common Clearing Link that the Chicago Board of Trade and the Chicago Mercantile Exchange have announced. The Chicago Board of Trade and the Chicago Mercantile Exchange, in the aggregate, account for approximately 85 percent of all U.S. futures exchange volume. Therefore, this initiative holds the promise of providing certain benefits for which we have long argued. To this end, we have advised the leadership of both exchanges that we stand ready to work with them to resolve the numerous questions that are certain to arise as the business and operations detail of their arrangements are implemented.

We understand that the exchanges may ask the Commission to approve the rule amendments and other actions that they will take to implement this agreement. Because the proposal may have an impact on markets generally, we fully support that decision.

Launching security futures was an enormous and expensive undertaking. Without the joint efforts of all industry participants, trading could not have been initiated in November of 2002. Although volume on these markets has not been as robust as we would like, we recognize that a bear market is not an ideal time to introduce futures on equity securities. Nonetheless, we continue to believe that this is an important product that will grow over time.

As Chairman Newsome reported, the CFTC and the SEC have not been able to agree on the rules that would permit securities futures products that are traded on foreign exchanges to be offered in the United States to U.S. customers. Consistent with the CFMA's purpose of promoting fair competition among boards of trade, we had assumed the necessary rules, regulations, or orders permitting the offer and sale of foreign security futures products to U.S. persons would be adopted contemporaneously with the rule authorizing security futures products on U.S. exchanges. We request that the subcommittee encourage the Commissions to act promptly to fulfill this congressional mandate.

In light of the significant structural changes that the futures industry is undergoing, we welcome Chairman Newsome's recent announcement that the Commission is planning to conduct a review of self-regulatory organizations with the goal of encouraging further the modernization of their rules and regulations. Governance, of course, is the hot topic of the day. However, it is one that the FIA has been discussing for many years.

FCMs have argued for some time that their interests are not adequately represented on the boards of directors of various contract markets or of some clearing organizations. Our views in this regard are consistent with those of the Group of 30. In a report on "Global Clearing and Settlement", the Group of 30 noted: "Where an institution is user-owned, the interests of shareholders and users are already likely to be substantially aligned, and representation of other important stakeholders such as end-user investors and issuers and the wider public interest can be achieved through appropriate appointments. Where nonusers have an ownership stake in a private institution, then additional strengthened mechanisms may be needed to ensure users have appropriate representation. This is vital where users have no or very limited choice of institutions from whom they can procure services."

We are also pleased that the Commission intends to review the roles, responsibilities, and the capabilities of self-regulatory organizations in the context of the market changes that are taking place.

And in conclusion, Mr. Chairman, I want to thank you and the members of the subcommittee for inviting me to appear today. The futures markets are prospering in the United States, and we are committed to their continued success. When we next appear before you, we hope to be able to report that the vigorous competition that Congress anticipated in enacting this legislation has become a reality.

Thank you very much.

[The prepared statement of Mr. Damgard appears at the conclusion of the hearing.]

Mr. MORAN. Mr. Damgard, thank you for accepting our invitation to be here.

We now turn to Mr. Robert G. Pickel, chief executive officer, International Swaps and Derivatives Association of New York.

STATEMENT OF ROBERT G. PICKEL, CHIEF EXECUTIVE OFFICER, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, NEW YORK, NY

Mr. PICKEL. Thank you, Mr. Chairman.

Mr. Chairman and members of the subcommittee, I appreciate your invitation to testify on behalf of ISDA. We have appeared frequently before this subcommittee, and we welcome the opportunity to be here today in your important oversight hearings on the Commodity Futures Modernization Act of 2000.

ISDA is an international organization, and its more than 600 members include the world's largest dealers in swaps and other off-exchange derivatives transactions, or OTC derivatives. Our membership also includes businesses, financial institutions, governmental entities, and other end-users that rely on OTC derivatives to manage the financial, commodity market, credit, and other risks inherent in their core economic activities.

Congress adopted the CFMA with broad bipartisan support after careful consideration over several years by four congressional committees and with the support of members from the President's Working Group on Financial Markets. The CFMA sought to modernize the Commodity Exchange Act by providing regulatory relief for the futures exchanges, by ensuring legal certainty for OTC derivatives, and by removing the ban on single-stock futures trading.

ISDA's principal interest in the CFMA is the legal certainty it provides for OTC derivatives. Legal certainty means simply that the parties to an OTC derivatives transaction are certain that their contracts will be enforceable. The CFMA framework is based on a long-standing consensus among Congress, the CFTC, and others that OTC derivatives transactions are not appropriately regulated as futures contracts.

Congress intended that the legal certainty provisions of the CFMA reduce systemic risk and promote financial innovation. The experience since enactment suggest that these objectives have been achieved. The use of OTC derivatives to hedge interest rate, foreign currency, and credit risks has increased substantially in the last 2 years as companies have used OTC derivatives to manage risks in periods of economic downturn and uncertainty. As Federal Reserve Chairman Alan Greenspan noted before the Senate Banking Committee last year, OTC derivatives "are a major contributor to the flexibility and resiliency of our financial system." ISDA believes that the legal certainty provisions of the CFMA and the related provisions of the Bankruptcy Code, adopted by Congress in 1990, enhance the ability of market participants to deal with such events.

The legal certainty provisions of the CFMA have also fostered financial innovation, encouraging dealers to develop and businesses to use new OTC derivatives products to manage additional types of risk. For example, credit default swaps have been used increasingly to manage credit risk. Similarly, businesses ranging from ski resorts to beverage producers to farmers are using weather derivatives to protect against the adverse effects of climate on their businesses. The CFMA also removed regulatory barriers to clearing of OTC derivatives, which has become increasingly viable as a result.

For these reasons, ISDA shares the views expressed by CFTC Chairman Newsome to this subcommittee earlier this month that the CFMA was "the right legislation at the right time." In this connection, ISDA believes that the CFTC and Chairman Newsome in particular, should be commended for the evenhanded manner in which it has interpreted and administered the CFMA as well as for its effective program of enforcement.

The last 2½ years have been marked by many market stresses: first and foremost, the economic downturn. There is no question that OTC derivatives have enabled firms to deal with the downturn in an effective manner, something made easier in light of the CFMA. Other events, such as Enron's bankruptcy and the California energy situation, have presented additional tests. Enron raised serious concerns involving accounting practices, securities law disclosures, and corporate governance policies, which have been given attention by policy makers, particularly through enactment of the Sarbanes-Oxley Act. The CFTC and other regulators have conducted intensive investigations and have initiated a broad range of enforcement actions.

ISDA believes that had Enron complied with accounting and disclosure requirements, it could not have built the "house of cards" that eventually led to its downfall and that OTC derivatives did not cause or materially contribute to Enron's failure. Observers of the California energy market have pointed to a multitude of factors contributing to market disruption: the design of the California electricity market, the lack of adequate reserves, supply response relative to growing electricity demand, and possible manipulation of the wholesale market for electricity. ISDA views any credible allegations of "manipulation" as a serious matter worthy of investigation by appropriate authorities, and both FERC and the CFTC have initiated enforcement actions arising out of the events in California.

What is most important is to restore confidence in the energy markets, and here steps are already underway in the private sector. These steps are detailed in a report that ISDA has published on it, which is available on its website. Among many factors, we identified the regulatory framework, as enhanced by the CFMA, as one of the factors that was effective in countering the fallout from marketing events. The CFMA has helped markets remain stable and, more recently, rebound.

Let me conclude, Mr. Chairman, by observing that the CFMA provided legal certainty and regulatory clarity for OTC derivatives in a manner consistent with the long-standing policies of Congress and the CFTC. The CFMA materially reduces systemic risk and encourages financial innovation. The recent economic downturn and the manner in which the OTC derivatives markets functioned in the collapse of Enron and the California energy market situation have confirmed that the policy judgments Congress made in 2000 were sound then and remain so today.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Pickel appears at the conclusion of the hearing.]

Mr. MORAN. Thank you very much, Mr. Pickel.

Our next witness is John G. Gaine, who is the president of the Managed Funds Association. Welcome.

STATEMENT OF JOHN G. GAINE, PRESIDENT, MANAGED FUNDS ASSOCIATION, WASHINGTON, DC

Mr. GAINE. Thank you, Mr. Chairman and members of the subcommittee, for the opportunity to be here this morning.

I have submitted a detailed written statement, and I, with your permission, would just highlight a few points of that and hopefully the stop-blinking button won't come on, and I will finish prior to that.

Mr. MORAN. Mr. Gaine, you have my permission.

Mr. GAINE. Thank you very much, Mr. Chairman.MFA is a national trade association with approximately 700 members that represent the managed futures, hedge fund, and fund of funds industry. Our membership is comprised primarily of CTAs and CPOs, hedge funds, and fund of funds managers who manage a majority of the estimated $600 billion invested in managed futures and hedge fund investment vehicles worldwide. Of that $600 billion, a significant portion is managed by firms that are registered as CPOs and CTAs. Many of our members act as purchasers of future industry services and thus are the indirect and direct beneficiaries of market protection provisions of and rules promulgated under the Commodity Exchange Act.

Many of our members are regulated by a host of other agencies as well. The public offer and sale of interests in commodity funds are subject to the Securities Act of 1933, the Securities Exchange Act of 1934, as well as the State securities laws of all 50 States. These are issues that we would think that we can address with this subcommittee and other relevant committees of the Congress and promote some efficiency of regulation with respect to them. MFA also will be subject to all of the anti-money laundering requirements of the USA PATRIOT Act when they become effective in the very near future.

Over the past year, alternative investments, particularly hedge funds, have received a great deal of attention by regulators, legislators, investors, and the media. Apart from our efforts in working with the CFTC in recent years and new rule-makings, which I have set forth in detail in my written comments, we have been working closely with the SEC in its fact-finding mission covering the hedge fund industry that began in May 2002. Last month, I had the opportunity to participate in the SEC's "Roundtable on Hedge Funds" along with a number of other distinguished panelists, including SEC and CFTC Commissioners and staff. The Roundtable was an excellent opportunity for the hedge fund industry to debunk many of the myths surrounding it, such as the notion that this segment of the financial world is unregulated or lightly regulated. In fact, over half of the managers of the world's 100 largest hedge funds are regulated by the MFA. Of those remaining, a significant number are registered investment advisors with the SEC. As was made clear at the Roundtable, hedge funds are subject to a host of regulatory requirements, including the anti-fraud and anti-manipulation rules of the SEC and CFTC.

Sound regulation of this important segment of the sector of the financial world managed futures; it provides many benefits to the global marketplace. Hedge funds, as do commodity pools, seek to provide investors with investment opportunities not highly correlated with traditional stock and bond investments. These vehicles provide much needed liquidity to the commodity markets, particularly agricultural markets, which serve to increase the efficiency of the price discovery and hedging functions of these markets.

With respect to the implementation of the CFMA, which is the main purpose of the hearing, let me just, in a broad summary conclusion, congratulate this subcommittee and the full committee for adopting the CFMA over a number of years. I think implementation by Chairman Newsome and the CFTC could not be better. They save the best until last, that is the CTAs and CPOs, but they have done a great job, and we couldn't be more praising of them and of the oversight of this subcommittee. They have a number of rule-makings. They have adopted one or two, and they have a number pending that will promote the efficiency of these marketplaces ultimately for our investors, which will increase their returns yet doing no harm to public policy.

And as I said, I have detailed the rules that are pending in my written document. We strongly endorse these undertakings, and we have one particular issue that we want to work with the CFTC and perhaps with this subcommittee and your sister committees in the Congress, and that is to coordinate regulation of public commodity pools. Right now, there are horrendous, duplicative, inefficient, costly barriers to entry to this industry by virtue of the bifurcated jurisdiction between the CFTC and the SEC. I would hope that Chairman Newsome will be able to sit down with Chairman Donaldson and with the support of both committees be able to iron that out and make it more efficient.

And just in closing, I would like to share Mr. Damgard's comments that any time there can be developed practical, efficient, competitive choices, the consumer or the investor wins out. And to the extent that that can be done and furthered by the Commission, that the Government has a role, I strongly support it.

And on that note, it hasn't—oh, it started to blink. I am sorry. I apologize, Mr. Chairman, but I am finished. Thank you.

[The prepared statement of Mr. Gaine appears at the conclusion of the hearing.]

Mr. MORAN. Thank you very much, Mr. Gaine. One of my colleagues asked me this morning if the red lights only showed at this direction, and I wasn't certain of the answer to that question. We are delighted to have your testimony, and it is very difficult for anyone to summarize the knowledge of information that is contained in the testimony in a matter of 5 minutes.

Our final witness is Mr. Daniel J. Roth, who is the president and chief executive officer of the National Futures Association. Welcome.

STATEMENT OF DANIEL J. ROTH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL FUTURES ASSOCIATION, CHICAGO, IL

Mr. ROTH. Thank you, Mr. Chairman. I will be the last panelist to take a shot at the 5-minute mark here.

You noted in your opening comments that there are several new members of the committee, and if I could, maybe I could just take a second and explain NFA's role in the futures industry.

Because as the industry-wide self-regulatory organization, we really occupy a unique position in the futures industry. Like the exchanges, we are a self-regulatory organization, but unlike the exchanges, we don't operate a marketplace. We don't engage in any commercial activity. Self-regulation isn't part of what we do; it is all that we do. We are a customer protection organization. Like FIA and MFA and ISDA, we are a membership organization. Unlike them, however, we are not a lobbying organization.

Our membership includes roughly 4,000 member firms. They include all of the firms that are registered under the Act as FCMs and commodity pool operators and commodity trading advisors and introducing brokers. Our membership also includes 50,000 account executives that work for those member firms and that are subject to our jurisdiction. We have been around for about 20 years, and throughout that 20-year period, we have worked in very close partnership with the CFTC. And I am not sure that everybody is always aware of it, but over that 20-year period, while trading volume on the U.S. futures exchange has increased by over 400 percent. During that same period of time, customer complaints filed with the CFTC and with NFA have dropped by over 70 percent. And I think that is a remarkable statistic, and it is a process that we have been proud to be a part of.

The CFTC and NFA share the same goals. We want to provide effective regulation, regulation that is effective in protecting customers and in protecting the public's confidence in our markets, and efficient regulation that doesn't impose undue barriers. And the CFMA was a huge help to both the regulators and the industry in achieving both of those goals in ensuring that regulation is both effective and efficient. We have noted in our written testimony the long list of accomplishments that the CFTC has had over the last couple of years in implementing the CFMA. Along with all of the other panelists, we would like to commend the Commission and Chairman Newsome for their great leadership. They have really moved dramatically toward core principles. They have reduced regulatory burdens. They have preserved and enhanced customer protection, and we think that their accomplishments have been significant and noteworthy, and we certainly compliment them for that.

I wish I could sit here and tell you that the CFMA had solved all of our regulatory problems, but clearly, no piece of legislation can do that. And if I could, I would like to take a minute and talk from our point of view about one customer protection issue that has come up after the CFMA has been passed, and that has to do with retail Forex transactions.

The CFMA tried to clear up the confusion about whether off-exchange foreign currency transactions offered to retail customers would be subject to the Commodity Exchange Act. And the CFMA basically provided that if you were an otherwise regulated entity, such as a broker-dealer, or an FCM, a bank, or an insurance company, you could participate. You could offer retail customers off-exchange foreign transactions outside of the regulatory provisions of the Commodity Exchange Act. And the idea was that if you are an otherwise regulated entity, well, then some regulator someplace is looking at you and could monitor your activities and ensure that customer protections were being provided. That is not exactly the way it has worked out.

It hasn't exactly worked out that way, because of some of the language in the Act. The language in the Act focuses on counterparty, and it provides that if the otherwise regulated entity is a counterparty to the transaction, is a counterparty to the retail Forex trade, then it is outside the regulatory provisions of the Commodity Exchange Act. Well, that leaves open the possibility that although the regulated entity is the counterparty, the people actually selling the products to the public, the people working the phones, the people soliciting these retail customers might be completely unregulated. And that is exactly what has happened. We are aware of instances in which hundreds of firms and individuals that are completely unregulated are soliciting retail customers for off-exchange Forex transactions. And they are doing it outside of the regulatory provisions of the Commodity Exchange Act because of the language of the statute.

I am aware that certain of those firms are actually firms that have been subject to the anti-fraud actions and the regulated markets. They have been subject to NFA or CFTC fraud actions, and they have left the regulated markets, and now they are occupying this niche. This is not a good thing. It is not a good thing. We have had a significant number of customer complaints, and we have worked too long and too hard to see those complaints come down to ever let them go back up.

We are working very closely with the CFTC and with the entire industry. I want you to know what we have done about the problem. Our Board has recently passed a package of rules, creating a category of retail Forex transaction merchants, retail Forex dealers. And those rules provide that those Forex dealer members of NFA will be held vicariously liable for any fraudulent solicitations committed by any unregulated members that are soliciting on their behalf—excuse me, on the unregulated entities soliciting on their behalf.

Our rules also have other provisions regarding supervision and handling of customer funds and so forth. We hope very much that these provisions will address the problems that have been created here. We will certainly keep you informed. I want to make sure, if I didn't mention it in my written testimony, that I note that FIA was a huge help to NFA in drafting these rules, and we appreciate their support. And if these rules don't provide an adequate solution to the problem, we will certainly come back and notify you of that fact.

The red light is blinking, so I will just conclude by saying that NFA also is very active in the SFP in getting single-stock futures. We became recognized by the SEC as a limited-purpose national securities association. We have been monitoring our members closely for compliance with the rules that we adopted, and thus far, we have seen no customer complaints in that area. And that is something that we are gratified by.

And the last thing I would say is that there is not a member of this panel that is a bigger believer in self-regulation than I am. I have been a part of self-regulation for 20 years, and I think self-regulation has served this industry enormously well. And I think a big part of the success of self-regulation has been the Commission's oversight of that process. There are certain conflicts of interest inherent in the self-regulatory process, and the CFTC's oversight and management of that process has been a key to our success.

And I join John Damgard and others, I am sure, in welcoming Mr. Newsome's comments that he thinks it is appropriate to review whether changes in the industry require any changes in the Commission's method of overseeing self-regulatory bodies. We think that is an appropriate inquiry whether or not changes are necessary or unnecessary. It is certainly appropriate to make the inquiry, and we are certainly going to do everything we can to support the chairman in that regard.

Mr. Chairman, thank you again. I missed the red light opportunity here. It is blinking, so I will conclude, and I will be happy to answer any questions.

[The prepared statement of Mr. Roth appears at the conclusion of the hearing.]

Mr. MORAN. Thank you very much, Mr. Roth.

Let me ask a few questions, initially, and see what other members have to inquire of. Mr. Damgard, your testimony, one of the things that caught my attention, although the vigorous rivalry that you had hoped for, and you indicate that Congress had anticipated putting a greater burden upon our level of anticipation knowledge than yours, hadn't materialized. And I am interested in why.

Mr. DAMGARD. Well, I think historically when the liquidity belongs to an exchange, it is very difficult for another exchange to come in and make an effort to try to take the liquidity away from that exchange. And so, for years, I think—I mean, for instance, the Board of Trade and the Mercantile have very successful contracts, but neither one has ever gone after the signature contract of the other exchange. And I don't think that there is anything mysterious about the decision. I don't think it is because they didn't like each other. I think it was because they thought that it would be awful difficult, once a successful contract has been developed, that the success begets success. And obviously, in other industries like the equity options world, the liquidity does not belong to the exchange. The liquidity belongs to the people who are involved in the market, to the users of the market in the name of the clearinghouse. And in those instances, it is encouraged, new entries into the market, because everyone has access to that same pool of liquidity.

Mr. MORAN. You relate a lot of what appear to be the transaction costs of participating in the market to the cost of clearing. I have never been able to get a good feel for what portion of the cost of the transaction is related to clearing.

Mr. DAMGARD. I think the Exchange is best to talk to that subject. I know that the Mercantile has an all-in charge for both the transaction costs and the clearing costs, and until very recently, the Board of Trade has had a transaction fee that differs from one liquidity provider to another. And then an independent clearinghouse, the Board of Trade clearing corporation charges a specific fee for clearing that trade. And perhaps they would be more accurate in supplying you with those numbers.

Mr. MORAN. Let me ask you one more question, Mr. Damgard, and then I will turn to the exchanges. In Mr. Duffy's testimony, he talks about what he believes are legitimate concerns with foreign exchanges. And he has a list of items that he thinks are important and apparently differential between a foreign exchange and a U.S. exchange. Is that list—do you share those same kind of concerns?

Mr. DAMGARD. No, I don't. I mean, I have not reviewed the list, so I reserve the right to change my mind. But I think both Mr. Duffy and I have had non-U.S. citizens on our board, and certainly at least 20 percent of the volume coming to the U.S. exchanges comes from foreign customers. Those foreign customers, I suspect, are just as elusive in terms of the long arm of the CFTC, if, in fact, they are found to be manipulating the market. But I don't see those concerns as concerns that we would be worried about. We are very, I mean, interested in any new exchange coming to the United States that meets the qualifications of the CFTC's definition of a contract market entering. Competition is very healthy, and I think we need more of it in our markets.

Mr. MORAN. Well, Mr. Duffy, let me allow you the opportunity to respond, but I assume that the integrity of the market is very important to you as well as to Mr. Damgard. And just the entry of a competitor without the opportunity for CFTC to ensure, as best as a regulator can, the integrity of that market, that has got to be troublesome.

Mr. DUFFY. Yes. Well, I would like to comment on a few things. The Chicago Mercantile Exchange was built on competition. We became the largest exchange in the United States. We are a public company today. We were built on competition, so we welcome it. Our concerns are very simple. We want to make certain that we are competing on the same playing field as any of our competitors. That is all we have ever asked. As John said, I have had conversations with him about this. That is all our concerns are is that the competition is a level playing field.

When you have foreign ownership coming into this country, which we have not had as a derivatives exchange yet, all we are asking is there are certain issues that need to be looked at. And we understand the Commission. We have great faith in the Commission. We are certain they are going to do it, but that is really how we feel about it: as long as the playing field is level.

Mr. MORAN. My time is expired.

Mr. Peterson.

Mr. PETERSON. Thank you, Mr. Chairman.

I want to zero in on these comments you made about the—well, not directly with the COOL legislation, Mr. Duffy. But before we get to that, would you describe the activities of the Exchange related to the monitoring of the cattle markets during the recent finding that a cow from Canada was infected with BSE and then some reports that some of the cattle around the same farm came into the United States and so forth? Could you tell me what your involvement was with that?

Mr. DUFFY. Well, we worked very closely, obviously, with the CFTC when the Canadian ban was announced by the USDA so that we protect the interest of all of the people that are involved in our cattle complex. Obviously, this is a great concern not only just to the Chicago Mercantile Exchange but to the industry and the economy as a whole. When you have potentially—when you cut off the supply of a foreign country on trade of a certain product, it has to be done in a very expeditious way to make certain when you turn that supply back on, if and when they are going to turn it back on, I don't know the answer to that, it is done in a most prudent way. And we have markets, and we have regulatory people. Again, I think I have said it in my testimony earlier, that the Chicago Mercantile Exchange is committed to regulation as a self-regulatory organization. And we just want to work closely with the USDA and the CFTC to make certain that we are in complete compliance.

Mr. PETERSON. I guess I didn't pay much attention, but did it have a significant effect on the futures market when this——

Mr. DUFFY. They are futures markets, so they can be influenced by a number of contributing factors, but when the news came out of the potential mad cow disease and with Canadian cattle being affected, the market impact was negative, obviously. The market went down.

Mr. PETERSON. How much?

Mr. DUFFY. It went down the permissible limit, which was 150 points, which has a dollar value of $600 per contract. It recovered immediately the following day.

Mr. PETERSON. I am interested in your comments on this country of origin labeling. I understand the concern because the cattle that are being dropped right now are going to be subject to this law, if it becomes law. I am curious as to—I hadn't really thought about the impact of all of this on your futures contracts, but is your concern—I am a little unclear as to what difference it would make. Are you saying that this law is actually going to effect the price of American cattle versus Canadian cattle, for example?

Mr. DUFFY. I am not saying that. I am saying that we have contract specifications that go into it, and people know what those contract specifications are, the hedgers know the rules when they participate in our markets. And if, in fact, when they make or take delivery against our cattle contract, they have to know what those specifications are and what is going to be involved, especially when it comes to law and what cattle can or can not be delivered against our contract. And we list contracts 12 months in advance on certain products. Our cattle contract will be listed out 1 year. We are concerned, because we don't want to have a cattle contract out there where we don't know what the specifications are going to be against delivery. So that is one of our biggest concerns.

Mr. PETERSON. Some of us have been talking about looking at maybe introducing legislation to require a mandatory animal ID of livestock in this country, not so much because of COOL but from a food safety point of view. I think, given what happened in Canada here and the effect that it had even though there probably wasn't any impact to the United States, and it still isn't over. I think we have got some problems out there, but it just seems to me it points out the danger we are in here. If we don't have some way to trace this stuff, terrorists could easily—I don't know easily, but they could potentially get hoof in mouth disease into this country. And it would cause us big problems if we weren't able to trace that back in a hurry and figure out where it came from. So do you have any—have you looked at that issue at all?

Mr. DUFFY. No, I will make the comment that obviously we share your concerns, as all Americans do. Again, the legislation that you are talking about, I am not certain of exactly what it is, so for me to comment——

Mr. PETERSON. Well, we haven't introduced it yet.

Mr. DUFFY. Right.

Mr. PETERSON. We are just kind of talking about it.

Mr. DUFFY. So I would be interested to see how that progresses and love to be—have the Chicago Mercantile Exchange participate a little bit in that conversation. But again, I think that until we see where it is going and see what the impact would be, it would be difficult for me to comment on it. But I share your concerns, as all other Americans, I am sure, do.

Mr. PETERSON. Thank you. Thank you, Mr. Chairman.

Mr. MORAN. I would recognize the gentleman from Texas, the ranking member of the committee, Mr. Stenholm.

Mr. STENHOLM. A lot of talk about derivatives now in light of Freddie Mac, and what have you. I would love a little general discussion from those of you that this is applicable to in the derivatives market to reassure me that we have the liquidity, the margin requirements if, and probably when, the interest rates begin to go up again. I understand the beef market. Prices go up. Short sellers have to cover. Talk to me a little bit about derivatives and if we should suddenly get into an increasing interest rate increases that we are going to be okay.

Mr. CAREY. I would like to say that really the discipline that is in place today that has really, I think, contributed to the success of the exchanges is as it relates to clearing, it is marked to the market on a daily basis. And it is very transparent as to who owns what and how it is going to be paid for. And there are very strict rules. So the exchange discipline, which may differ somewhat from the OTC discipline—I wouldn't want to confuse what we do with some off-exchange transactions that really suffered from counterparty risk and weren't subject to the same discipline that we are on a daily basis. And I think that that is really the biggest difference when we look at these markets together.

Mr. GAINE. With respect to—you know, I sit here on behalf of funds, which are users of derivatives, both Mr. Carey's and Mr. Duffy's and Mr. Pickel's. Long-term capital management, which you well remember in 1998, spawned a number of hearings. But more importantly, it spawned a focus by all of the banking regulators throughout the world, particularly domestically as well as the Securities Exchange Commission and prompted a number of industry self-developed remedies. There was a counterparty risk management group of the dealers, co-chaired by Gerald Parrigan and Steve Teak, which had tremendous recommendations and efforts to collateral, market-to-market evaluation risk control. MFA developed, for the hedge fund manager, and it is referenced in my testimony, sound practices for hedge fund managers, which are in the process of updating. But I think if you look at the world post-long-term, you are going to see ten volumes of regulations and guidance addressing the question of collateral, leverage, risk, et cetera. And I think Mr. Pickel probably, since his organization is responsible for one of the master contracts in this entire area, probably would have some very good insight on this subject as well.

Mr. PICKEL. Yes, I think that is right. I mean, the OTC world is based on this bilateral relationship. And it is very much credit-sensitive, so the participants, the users of those types of contracts have very sophisticated methods of analyzing credit, having credit exposures. What I think—so that they will be able to manage that credit risk.

They have also increasingly used collateral. We do an annual margin survey. We call it a survey of the use of collateral in the OTC derivatives world. And we have seen increasing numbers of parties use collateral in their relationships and an increasing volume of collateral used in that relationship, which I think is there to provide some additional cushion in addition to that credit analysis that is done. I think that it is important to keep in mind with the GSEs that their ability to use derivatives has been critical to their success in delivering products that are useful to all Americans: rate locks on mortgages, the ability to so easily refinance, and also things like variable rate mortgages. It is important to have those tools available to the GSEs, and they have been very successful users of those.

Mr. STENHOLM. I guess one of the reasons for my question; I remember the S&L situation that happened in Texas. And I can see the broad makings of a similar type of scenario unless we have the market-to-market, the margin, the collateral, and all of the things in place to cover that. And I guess what you are telling me is that you believe that in your respective associations and your respective fields, you believe that it is adequate today.

Mr. GAINE. I believe it is. I think post-long-term is—I mean, I am not that familiar with the inner workings of Freddie Mac. But the role of derivatives, as Mr. Pickel was suggesting, the Controller's Office, the overseer of the national banks, just last week it was the Deputy Controller of the General Council said that they urge their banks to use derivatives to control the risk. So there is a risk-reducing role here for derivatives every bit as much as there is a speculative. My people generally would use it on the speculative, whereas others might use it more for risk control. But I think the world has changed dramatically since 1998, and——

Mr. DAMGARD. I would just say, Mr. Stenholm, that the collective deep pockets of the clearing member firms really protects the exchanges. I may be a customer of the Board of Trade, but I access the Board of Trade through a clearing member, and that clearing member belongs to the clearinghouse. And the clearinghouse takes the opposite side of the trade, and the record has been really quite spectacular, so I would agree with Mr. Carey that the exchange traded products are extremely safe.

Mr. DUFFY. If I could comment on that again for one more second, Mr. Chairman, because I think it is an important thing to note. At the Chicago Mercantile Exchange, in the 105-year history, we have had a zero default. We have never had a customer lose money because of a default. Our clearinghouse, as Charlie mentioned, is market to market. We do it twice a day that the market volatilities are such we can do it on an hourly basis. So it is basically a zero sum game. This is exactly the way it is supposed to be. We think it is the most appropriate way for us to manage risk.

And I think when you look at our Eurodollar contract, which was originally a liabilities and asset managers' contract, it still is today, it is the largest contract in the world. Also, if you look in that contract, you will see a lot of refinance people in that contract putting their business on exchange because of the market-to-market and the security of central counterparty claim risk.

Mr. CAREY. Just one final comment. Derivatives tend to get labeled and grouped. And I think that this particular issue that we are referring to is more about accounting rules, more about management, and I don't think derivatives, whether on-exchange or off-exchange, should be labeled in one fashion or another. It is really about the management and the accounting and the transparency of the bookkeeping outside of our environment. It is not just derivatives that are bad or good.

Mr. PICKEL. I think you are certainly right to look at the S&L situation as precedent because of the mismatch between the asset base and the liability base of the S&L's. I think that they were not as extensive users of derivatives at that time, because it was an earlier stage in the development of the product. I think you see with the GSEs they are very actively managing that asset and liability base. And I know that with Fannie Mae there was concern when their matching—there was a 6-month lag in their matching up of the underlings with the derivatives, but they have reduced that. So there is that focus on matching up the underlying exposure with the hedging that they used derivatives for to address that asset base.

Mr. MORAN. Mr. Etheridge is next. We do have two votes. I anticipate coming back and allowing any Members who have questions. Mr. Etheridge, if you can come back, we will save your question, because it doesn't appear to me that there are quick answers, unless you anticipate a different response.

Mr. ETHERIDGE. I think mine will be in a little different direction and would be pretty quick.

Mr. MORAN. Okay.

Mr. ETHERIDGE. Thank you, Mr. Chairman. Thank you for holding this hearing. Thank you, gentlemen, for being here. And I am pleased to hear that implementation of CFMA has progressed smoothly. And while I appreciate the support, the growth of trading and single swaps, energy futures, and all of the financial pieces, it seems to me we have got to start in agriculture. And let me go back to that, if I may.

Mr. Carey, in your testimony, you talked about your concerns about foreign owners and exchange seeking to establish themselves here in the United States and the trading products here. Let me ask you, if another exchange does set up here, do you expect they will be offering futures and options for U.S. agricultural products or would their coming to America really help the American farmer?

Mr. CAREY. Well, I am not sure of their plans. I have only heard various reports that they may offer agricultural futures, agricultural products. And as far as—our position is concerned, as I said in my remarks, there are issues. The issues that have to be explored are the integrity of the marketplace, the customer protections, and national interests. And from that standpoint, we are very confident that the CFTC will carefully and fully review these.

Mr. ETHERIDGE. Well, I guess my question is would it help or would it not help the American farmer?

Mr. CAREY. Would it help?

Mr. ETHERIDGE. Yes or no? I mean in your estimation.

Mr. CAREY. I don't think it would.

Mr. ETHERIDGE. You don't think it would? Okay. Then if it would not, let me just raise the issue of what is the point of them coming here? I understand that they want to come and to trade in U.S. financial and the stock futures and options because that is where the volume is, and obviously, that is where the profit is. But if they are not interested in trading in contracts for farmers that farmers can take advantage of, which is what the market is about, then we are talking about an agricultural issue that has really turned into a total financial issue, if that is what I am hearing. Is that correct?

Mr. CAREY. Is it a total—I don't know that it can be characterized as a total financial issue, because we don't know what their plans are; a lot of it is hypothetical, if they were to list these products and what effect would it have. So from where I am sitting, we are talking about the CFMA and its effect on all of the markets.

Mr. ETHERIDGE. Okay. So the answer is you don't know?

Mr. CAREY. That is correct.

Mr. DAMGARD. When I sat here in 1974, virtually all futures contracts were based on agricultural commodities, and I was the Deputy Assistant Secretary of the Agriculture Department and have great sense of pride in this Act. And we believe that opponents of the jurisdiction use this argument all of the time, that I guess the markets are more financial now. But the institutional knowledge of how this Act has progressed resides with this committee. And we do not know whether they are going to come and offer agricultural products or not. They have not said anything about their plans. They have talked about getting into the equity options business, and they have announced that their intention is to also trade products that are currently traded exclusively either at the Chicago Board of Trade or the Chicago Mercantile Exchange.

Our belief is that competition improves the product. And we believe that if they come here and their system is a good system, they may very well offer electronically traded products. And if they do, we presume that the Chicago Board of Trade will respond in a very competitive way to make sure that they are not outdone in the marketplace. But the direct answer to your question is yes, agriculture commodities are not as prominent as they used to be in the big picture, but they have still grown dramatically. I mean, of the 400 percent increase in the volume in the market since I have been around, most of it has been in the financials, but it is because the financial community, who realized how well these instruments have worked from the agricultural community. So we are very much interested in making sure that the markets are responsive to the agricultural needs of the American farmer and rancher.

Mr. MORAN. Mr. Damgard, you can conclude.

Mr. ETHERIDGE. Thank you.

Mr. MORAN. I don't know whether Mr. Etheridge can return. I am hoping that you will all be here. We will be back in about 10 or 15 minutes, and the committee will stand in recess until that time. I am sorry, Mr. Larsen.

[Recess.]

Mr. MORAN. We will return to order, and I appreciate Mr. Larsen's return, and he does have questions. And I recognize the gentleman from Washington.

Mr. LARSEN. Thank you, Mr. Chairman, and thank you for holding this follow-up hearing to our June 5 hearing.

My first set of questions are for Mr. Wolkoff and Mr. Pickel.

First off, I would appreciate the entire panel taking time out of what is obviously a very busy life that you lead. I am learning a lot about the commodity futures market being on this committee, and I didn't think I would, not that I didn't think we covered that, but there are a lot of other things going on in agriculture as well.

But there is an old line from the show "M*A*S*H" where B.J. Honnicut and Hawkeye are talking to each other, about Colonel Potter. And they are talking about doing something for him and they want to kind of be careful about the word getting out, becasue they say when Colonel Potter sees two flies talking he knows they are talking about a horse. So when you talk to somebody who is from Washington State and they are going to ask a question with regard to commodity futures market, you probably know they are going to ask about energy. And so that is why I have questions for Mr. Wolkoff and Mr. Pickel at first. And this gets back to one of Chairman Newsome's comments from June 5. And at the subcommittee hearing, Chairman Newsome said he believed that it may be appropriate to require that some traders in the OTC energy derivatives market be required to register with the CFTC and to keep records with regard to those transactions. And as you follow-up in the future, this is on page 44 of the transcript from the last hearing, if you need to get some clarification later on. But I want to know what your reaction is to that idea and what benefits or problems do you foresee arising from such a system. Mr. Wolkoff.

Mr. WOLKOFF. Not being familiar with the comment, did you say it was traders or brokers that——

Mr. LARSEN. Let me read you the transcript.

This is in response to some questions from Mr. Pomeroy. This is Mr. Newsome:

> As you know, the market was evolving. There are no complaints, so therefore no reason for us to really look into it. I think as we may have worked in our investigations, and I think there are some things that we should look at. And this went into Mr. Larsen's question of some kind of notice registering.

I was asking about the Senate legislation,

> So that we just know who the participants are in the marketplace, making sure that they are required to keep good records so that if we do have to come in, we

are guaranteed that there is going to be something there for us to look at. I know those kinds of things could be helpful to us,

that is CFTC,

with our after the fact regulatory scheme.

So that is the transcript.

Mr. WOLKOFF. Really, I am not familiar with the whole concept and would certainly not be in favor of some very broad scale registration requirement for individuals working at companies. I guess the one difference between the energy world and, say, my colleagues in the financial world is that the energy world is relatively finite. The companies that are involved in the over-the-counter market are generally no different from the companies that are involved in the futures markets. Their transactions might occur on the intercontinental exchange, which is not regulated, but still maintains records of trades. They might occur on NYMEX. They might occur on the International Petroleum Exchange. I think there is no shortage of understanding exactly who is in the market. I think sometimes the issue might be what are they doing and why are they doing it or in the past for look-back, it is what did they do and why did they do it.

So I think from our perspective, what we have found with respect to registration is that given the NYMEX's venture into clearing transactions that were executed not on our exchange but in generally the over-the-counter markets, we have been responsible for securing the registration of a large number of voice brokers, which is a huge part of the bilateral market in energy. And so one of the unintended consequences of us doing this is that now there is a much better handle on those intermediaries who are bringing transaction participants together. Their record keeping has been enhanced. There has been a great deal of transparency that didn't exist previously that now exists simply because the transactions have found their way to a regulated exchange. And to date, in the 1 year that that has been available, the service has cleared approximately 3 million contracts. So it has become very effective. It has brought a lot of the exchange oversight and discipline into the process. And I think it has made the look-back into what happened easier and not more difficult.

I hope that is somewhat responsive, if not precisely responsive, to your question.

Mr. LARSEN. Sure.

Mr. PICKEL. I think what Chairman Newsome may have been talking about are the different kinds of, in effect, marketplaces that might be created. And I think one of the innovations of the CFMA was to have these different levels at which people might be able to have an exchange or have some kind of one to many type of arrangement, which is what Enron online was where it was one party that you are always contracting with Enron. But you were, through that electronic interface, dealing with many different—Enron was dealing with many different entities. So there may be those types of situations where that something more akin to an exchange where that type of reporting makes sense.

If you step back and look at, again, the area that we focus on, the bilateral relationship, we really are talking about two parties contracting. They have their own needs and interests in entering into that relationship. They have their own information that they want to provide and information that they will want to seek from that counterparty. Keeping that information, updating it periodically, all of that exists as a result of the fundamental credit relationship that is created there. And so parties do, I think, have fairly extensive procedures for collecting that information, but I don't see a particular need to make that automatically available. I suspect it could be obtained if there was an issue of manipulation that might have occurred.

Mr. LARSEN. Any other panel members?

Mr. Chairman, I see my 5 minutes are up, but——

Mr. MORAN. You may continue, Mr. Larsen.

Mr. LARSEN. Thank you.

This set of questions is for, first really, Mr. Duffy and then Mr. Damgard and perhaps Mr. Carey as well. And this gets into the discussion about foreign ownership, creating a level playing field. And my question is this. If the future of the futures market has a publicly held exchange, mutually held exchanges, and then this other entity, foreign-owned exchange, and we are seeking to—and it is an appropriate public policy response to ensure that if there is a foreign—or that there should be a public policy response to a foreign-owned exchange in the U.S., have you all thought through what that might mean in terms of changes in regulatory approaches?

Specifically, Mr. Duffy, you were talking about essentially creating a level playing field, you used the term platform, I think, but creating a level playing field. Is regulating, short of saying you can't come into the market at all, regulating a foreign-owned exchange in some respects, does that squeeze the balloon in one part of the industry so that there are other—it has an impact on other parts in your industry that are going to call for regulations so that we do have that level playing field that you are looking for? Have you thought through what the regulatory implications are of the comments you have made about on the level playing field?

Mr. DUFFY. Well, I think that the CFMA has definitely been very helpful. We have all given testimony here earlier. So that is something that has leveled it and made us be more competitive, and we appreciate that. As far as a level playing field goes, my comments were that competition is something that the Chicago Mercantile Exchange was built on. So we don't have issues whether the competition comes domestically or internationally. All we are asking is that when it comes from international competition, there may be certain things that are not required to have happen by domestic institutions. So we are asking that it just—again, I can say it again. As long as it is a level playing field, we are more than willing to compete.

Mr. LARSEN. Does that mean if we can't—again, I am speaking from a point of learning about this market. Does that mean if a foreign-owned exchange comes into this market and as a result of being foreign-owned that we don't have the authority to regulate it in some respects because it is foreign-owned that we should remove those aspects of regulation from the domestically-owned exchanges or——

Mr. DUFFY. No, we are not asking for anything different as far as regulation goes in our businesses today that would in any way change the CFMA at today's present time. I don't think it would affect any other parts of our business with competition, whether it is foreign or domestic. So that is not the concern. The concern again is just where is this money coming from, who are the people that own this institution. When we talk about EUREX, it is owned by Deutsche and Borse which is also a publicly traded company, similar to us. We are a publicly traded company.

So we just want to make certain that we know that all of the risk management tools are in place for the safeguards of the U.S. customers and the competition is level.

Mr. LARSEN. All right. Mr. Damgard.

Mr. DAMGARD. As I understand it, and I don't want to become an apologist for all of the international exchanges, but one of the reasons why I think they are coming to the United States instead of just soliciting business for their German exchange is because the field isn't exactly level. There are tax benefits for U.S. customers who trade on a U.S. exchange. So I have no knowledge of whether or not the Mercantile or the Board of Trade have ever attempted to create exchanges outside the United States. My sense is that they have been very successful in attracting business from all over the world without the necessity of creating exchanges outside of the United States.

But as Terry mentioned, EUREX, I think, is 94 percent publicly owned, and it is largely owned by both British and U.S. financial institutions. It is my understanding that they are coming here and registering as a U.S. exchange and meeting all of the criteria that the CFTC sets down for U.S. exchanges. So they won't be a foreign exchange; they will be a domestic exchange. And our belief is that, I mean I have been here long enough to watch Credit Suisse acquire First Boston and UVS bought Paine-Weber and clearly a lot of activity comes from firms like Barkley's and other large international banks. Most of the Japanese brokerage firms have joined the FIA, so I am not so concerned about the fact that there is foreign involvement in our markets. In fact, I think that is probably good, and I think we lead the way in terms of sort of cross-border business. And the SEC, in a way, has a lot to learn from the CFTC with respect to making sure that cross-border business can be done more seamlessly.

Mr. LARSEN. Mr. Carey.

Mr. CAREY. Yes, just one remark. Whether it is foreign-owned or foreign-controlled, we have one specific concern and that is that the market integrity not be compromised. And I believe the CFTC is capable of working through these issues.

Mr. LARSEN. Mr. Chairman, thank you. That exhausts my questions, and I want to thank the panel members for taking time out today. And thank you, as well, for helping to educate a novice on this issue. I do appreciate that.

Mr. MORAN. Thank you.

The Chair would recognize the gentleman from Michigan, Mr. Smith.

Mr. SMITH. Mr. Chairman, thank you very much. And gentlemen, thank you for sharing your time and still have time for lunch, I think.

Although the Commodity Futures Modernization Act probably has influenced mostly non-agricultural trade and the expansion of that trade, as a farmer and inasmuch as the Agriculture Committee oversees the total trade, I am interested in hedging and future trading, particularly as it might apply to agriculture. And this committee, also under the chairmanship of Mr. Moran, also has the risk aspects for agriculture.

So maybe a question to Mr. Carey and Mr. Duffy and Mr. Damgard relating to possible changes that might better accommodate agricultural hedging. With some of my small farmers, one consideration might be special exceptions if they are a proven farmer and if they are hedging based on their agricultural production in a particular commodity, would it be possible to have a smaller trade than 5,000 bushels? How might we accommodate that and whether it is passing a law to do it or is there some way that the Chicago Board of Trade might accommodate that smaller trade?

And the other question, of course, is the margins for a true hedge, which are now a little lower, but could we accommodate and encourage a better risk management and better participation by farmers with maybe lower margins if it is a true hedge, if they have got an agricultural farm, if they have proven their yields and acreage with the U.S. Department of Agriculture for a smaller area?

And then my third question, for whoever might want to react to it, is is there a possibility they could be enough trade for the market to justify expanding hedging on some of the products that are inputs for agriculture, and I am—such as the nitrogen, phosphorus, and potash? Now we can relate, as I understand it, and help me understand it a little bit, now we can relate a little bit to nitrogen fertilizer based on natural gas hedging, which is, I suspect, somewhat directly related, but maybe getting your reactions and thoughts on how we might help farmers.

Mr. Carey.

Mr. CAREY. Well, on the first question, the Board of Trade already has a smaller contract. We call them mini ags; it is 1,000-bushel contract for soybeans, corn, and wheat. And it was as part of us absorbing the Mid-America Commodity Exchange.

Mr. SMITH. How long has that been going?

Mr. CAREY. Well, when I first started trading in 1976, there was the Mid-America Commodity Exchange, formerly the Open Board of Trade. The Chicago Board of Trade absorbed them somewhere around 1985. And we currently have a list of product of 1,000-bushel contracts, which are available at open auction in the same room that the large contracts are traded. So they are available today.

Mr. SMITH. And so brokers normally don't handle it, but they would if the farmer asked him to?

Mr. CAREY. Well, it is available, absolutely. And there were some farms that specialized in that particular area. On the fertilizer and some other components that perhaps people would like price protection, the Exchange tried approximately 10 years ago to list diamonium phosphate and another fertilizer contract, but we weren't able to build critical mass to the point where you could create a liquid market. And if they are not liquid, then you lose the participants.

Mr. SMITH. By liquid, you mean no hedgers and no speculators to make it legitimate?

Mr. CAREY. I mean broad-based participants so that there is a medium to the bid and offer and there is a depth of the market that is provided. And what creates that magic formula is something that we are always exploring to find new products to bring to people.

Mr. SMITH. Mr. Duffy, any comments?

Mr. DUFFY. You know what, I am just going to add a little bit to the fertilizer thing, because I think that I agree with what Charlie has said, but I also believe that business and industries change, and this is no exception. The fertilizer industry Charlie referred to 10 years ago is changed dramatically today.

There are a couple issues with the nitrogen in the fertilizer and issues like that. That is in how we deliver the contract as a physically delivered product and the liabilities that are associated alongside with it or do you want to have it a cash-settled contract. Personally, a cash-settled contract makes complete sense and takes some of the liability out of the delivery process of the contract. But I have actually talked with people on this issue, and they feel that the only way a contract could be successful would be to make it a physically delivered product. So to be honest with you, Congressman, we are working through some issues. I have looked into this very recently, and I hope to, again, put more work into it and see if we can come up with something at the Chicago Mercantile Exchange.

Mr. SMIT. So let me close that loop. What does that mean, looking into it?

Mr. DUFFY. Well, I don't want to sit here and tell you that I am going to launch a nitrogen contract tomorrow, but we always explore new products, and that is something that—innovation is what the Chicago Mercantile Exchange is all about. So we constantly look to bring new product to market to benefit the consumer, benefit the hedger, and obviously in doing that, we benefit the Chicago Mercantile Exchange. And so these are products that we are looking to launch, and this is one that is on our—right now that we are working on.

Mr. SMITH. Great. I think it would be a great help to farmers.

And Mr. Damgard, maybe expanding your remarks, if you can just—because my time is up, but also the cash market versus delivery and taking delivery, my experience as a farmer is that I can't do it. Of course, I am in Michigan, and Toledo is somewhat more removed now. But taking delivery in Chicago, they wanted to charge me, and I don't even know who "they" are, but just an enormous amount per day per bushel so that you can't take delivery unless you have a fleet of trucks or barges or something waiting to put it on your order ship. So I am a little concerned about if it is going to too much of a cash market that it does leave more flexibility than there should be in terms of the contracts representing the true market.

Mr. DAMGARD. Well, I share your frustrations. My farms are within about 30 miles of the Illinois River, so I have pretty easy delivery to the delivery points. But by the same token, the way these markets work, and the way they have really assisted the farmer is not necessarily directly to the farmer. My transactions are almost all exclusively with my grain elevator, and I can shop price either by the unit trains going down to New Orleans or with the barge traffic, depending on the level of the river. And it is the futures contract at the Board of Trade that allows that grain elevator to quote me a price. And so while I am large enough to participate myself, and I am also a hog grower, so I feather Terry's nest at the same time, who trades hogs at the Mercantile. Basically, the small farmer who looks to the grain elevator for his price protection and his risk management, and it has been my frustration that we haven't done a better job as an industry in allowing these products to be available to the retail customer.

My sense is that the USDA is now much more involved in the education than they ever were before. And there have been some pilot programs with respect to using options, but my sense is that the industry needs to continue to work. And yet, as Charlie mentioned, there are constraints on whether or not these contracts can be listed if there is not enough business to justify the profitability of that contract.

Mr. SMITH. Yes. Mr. Chairman, thank you very much.

In terms of the nitrogen or possible other chemical inputs or other fertilizers, that is one of the problems. Right now, you contracted ahead, but the suppliers and brokers for these that sell it to the farmers guess so high on what they will sell it to you a year from now, because they just don't want to make the mistake that they are selling it too cheap. So the problem is that you can't forward contract on a lot of the inputs, because they protect themselves with just a very high price as far as the contract requirements.

Mr. Chairman, thank you very much.

Mr. MORAN. Thank you, Mr. Vice Chairman.

The gentleman from Georgia, Mr. Burns.

Mr. BURNS. Thank you, Mr. Chairman. I would like to thank the panel for their input today. I apologize for being in and out as the day gets hectic around here. But it is good to have you here and sharing with us your expertise.I want to address standardization, an industry-wide, maybe, perhaps, attempts or the desire to move toward some standard protocols, some standardization of products or offerings. Perhaps, Mr. Duffy, if you could, what is your perspective on the issue from the industry perspective?

Mr. DUFFY. On standardization, as referring to what?

Mr. BURNS. As refers to common trading of products. It is interesting that, perhaps, the Chicago Exchange is more noted for cattle or Eurodollars or other exchanges noted for energy. Do you see yourself engaging in products and then standardizing the communication protocols between the exchanges? Are there any antitrust concerns there?

Mr. DUFFY. No, sir. I don't believe that is the case at all. I mean, as I said a moment ago, innovation is part of the hallmark of our exchange, and we constantly look to innovate product and bring product to market. So when you become successful in a product, obviously you want to market it and do whatever you can.

Liquidity is something that is essential to make these products function. And we have liquidity in certain products, and we have expertise in certain products, so that is the reason we trade them. Now we have competition throughout all of our products with over-the-counter that replicate the same as on-exchange trading. So and you look at the Chicago Board of Trade, they also have a Eurodollar contract. We have a Eurodollar contract. They have agricultural products that we trade, hogs and cattle. They trade them. So we don't believe there are any antitrust issues whatsoever.

We have fair and open competition. We don't have any exclusive to trade of these products with the exception of one, and that is what we have with the Standard Employers 500, with the McGraw Hill. Otherwise, all of our products can be traded by any other exchange and listed. Now should we be penalized because we have done a good job marketing products and built liquidity? I don't believe that is what they American way is all about. We have just done a better job than other exchanges. They do have our products. They are listed over-the-counter, and they do trade.

Mr. BURNS. So there is not an issue of proprietary products, per se?

Mr. DUFFY. No.

Mr. BURNS. Okay. As you look at the communications protocols, just the technology associated with it, can you give me a quick synopsis of where you are there and where the industry is moving, perhaps, Mr. Damgard?

Mr. DAMGARD. I am certainly not a technology expert, but I will say that the industry, particularly the firms going back to your first question, would very much welcome standardization in terms of accessing all of these markets. One of the concerns that I have had is that our members have, over the past 15 years, been more likely to put their top people in London, because they can take customer orders out of London and place those on exchanges all over the world with less regulatory interference. Now that really is not a CFTC problem. That is a problem that relates to whether or not the capitalization of the markets outside of the United States meets the test of the SEC. And these are things that I think they are working through right now.

But the exchanges have a different definition of competition than the firms. The firms offer exactly the same service to the very same customer base on identical products, but once they have that order from the customer, they have one place to take that order, and that is to a specific exchange. Exchanges will argue, and I think quite successfully, that there are other kinds of ways in which to manage risk besides going to the Eurodollar pit at the Mercantile or the bond pit at the Chicago Board of Trade. But we believe that the answer to an awful lot of the deficiencies lies in competition and not Government mandate.

Mr. BURNS. Thank you.

Thank you, Mr. Chairman.

Mr. MORAN. Mr. Burns, thank you.

Kind of a round of questions from me for Mr. Gaine and Mr. Roth. So-called hedge funds and their regulatory exemptions, they have been receiving a little bit of attention in recent days, and what role does the CFTC play in regard to these so-called hedge funds? And are these investments receiving the appropriate regulatory scrutiny that you believe they should?

Mr. ROTH. Mr. Chairman, I can respond in this way. The commodity pool operators are required to be registered under the Commodity Exchange Act, and there are over 1,000 CPO members that are registered with the CFTC and that are members of NFA. If there is a fund, which intends to trade futures contracts, it is currently required to be registered as a commodity pool operator. And therefore, many hedge funds are registered as CPOs.

There was a survey recently, and I think roughly 17 or 18 out of the top 25 hedge fund complexes have an affiliate that is a member of NFA and subject to NFA and CFTC regulation. I think it is 55 out of the top 100. So there is a considerable portion of the hedge fund community, which is subject to regulation by CFTC and NFA. I could tell you that over the years, CPOs in general, including hedge funds, CPOs and CTAs, constitute about 60 percent of our membership. They have accounted for roughly 2 percent of our customer complaints. So it has been an area, which has been pervasively regulated, but relatively problem-free for us. And we would certainly work with the CFTC to ensure that that remains the case.

The Commission has a number of proposals out right now, which would grant further exemptions from registration under certain circumstances based on the nature of the clientele or other facts. And certainly NFA has been supportive of those exemption requests. We sponsored one of them, but we don't think any of those exemption requests that the Commission is considering would, in any way, undermine the customer protection regulation of the commodity pools and commodity trading advisors generally.

Mr. GAINE. Yes, Mr. Chairman. Hedge funds, despite what you might read in the press, have not been, nor are they available, to retail customers. There is a very limited investor base of persons who can invest in hedge. They are either sophisticate investors, as defined by the SEC, or they are qualified purchasers, as defined by statute. A qualified purchaser for an individual is an individual who has $5 million in investments. A credit investor is an individual who has $200,000 of annual income for last year and this year or a net worth of $1 million.

As you know, the SEC is conducting an exhaustive study, and has been for over a year, of the hedge fund industry. And they had a Roundtable on May 14 and 15 at which Mr. Roth's conclusions about the absence of fraud basically in this hedge fund industry was pretty well established in terms of the number of funds, the amount of money under management, and the isolated, sporadic, problem areas. To answer your question specifically, I think they are appropriately regulated now, as I said in my testimony. They are subject to a barrage of anti-manipulation, antifraud statutes and various reporting requirements. They are subject to the PATRIOT Act and filing a notice requirement.

I think one thing that might be rethought is the $200,000 and the $1 million net worth requirement, which were set in 1982, and there is a feeling, which I don't find to be unreasonable, that $1 in 1982 is not quite the same as $1 in 2003. But I think the traditional hedge fund industry, with its limited pool of investors and its wide range of flexibility in trading has performed extremely well, particularly over recent years. And I think the degree of regulation is appropriate.

Mr. MORAN. The trend seems to me to be that we are determining levels of sophistication and basing a regulatory scheme based upon that sophistication. Is that the consensus of the industry that that is appropriate?

Mr. GAINE. Absolutely. That was, I think, the underpinning of the CFMA to match the level of regulation to the type of product and the type of investor. And I think that that is what Congress did in 3C7 and in private offerings and what the SEC has enforced very effectively, I think, through the years, you know. Someone said at a panel I was on 2 days ago in Chicago, and he is a very knowledgeable attorney. Of course he works for hedge funds, so he comes with objectivity. He said, “I feel like I am on Jeopardy.” And someone says, “Hedge fund managers have to register as investment advisors.” And he said, “What is the question?” “I don’t know what the question is.” We don’t know what the question is, but that seems to be an answer that everyone throws around. And I don’t like to take a solution searching for the problem. But I honestly feel after the 2 days and the other data and information that has been developed that no significant cases were made for any increased regulation, other than, as I said, this rather reasonable concept that $1 in 1982 might be different than $1 in 2003.

Mr. MORAN. Mr. Wolkoff, in our discussions with Chairman Newsome several weeks ago, we talked a lot. This subcommittee had a lot of interest in California, Enron, energy events that occurred in our economy. I think that the chairman’s point was that they have taken appropriate steps post the discovery of these problems as far as investigation and potential prosecution. I think the point was also made that no one would have seen this coming in advance of that. And do you think that is true that there were not signs that steps should have been taken? And if it is true, is there something more that we need when it comes to—you know, we moved in the direction of fraud and abuse in this area. I am not sure that your testimony would say that that is the standard that ought to be applied. And I just want to flush that out with you, if I could.

Mr. WOLKOFF. From what is known about both California and Enron, and although there are some intertwinings of the two, they are separate issues and separate events. In my belief, I think the vast majority of the problem areas don’t stem from Commodity Exchange Act regulation or matters particularly under that jurisdiction. It appears, in the case of California, certainly that what started out started as a bad idea. It was foreseen specifically by us. We testified at a number of places, including Capitol Hill and including California that it was a very bad idea, and it was taking what was developing as a competitive market and going backwards into a monopoly situation. And the reality is that the worst of what we felt would happen did happen.

Now at the side of that was the marketplace, I guess the term of art would be gained it companies like Enron or other energy merchants take advantage of the situation. And I think that has been the subject of the investigations, and that has been the subject of prosecutions. And as I understand it from what the chairman testified to and various other stories, there still are a number of open investigations and potential prosecutions related to how the deficiencies in that market were taken advantage of by individuals. But I believe that the underpinning of that whole situation was really the foundation of the market itself.

With respect to Enron, I have yet to see, with the exception of credit issues, that counterparties in energy lost money because Enron went bankrupt. I have yet to see the problems associated with Enron's lack of disclosure and general lack of business integrity and internally not appearing to follow any normal standards of accounting practices or self-policing. Those problems don't appear to have anything to do with transactions. To the extent that Enron was a competitor of ours and a fierce competitor of ours because Enron online became a transactional mechanism trading, among other things, look-alike contracts to what was on NYMEX, which leads me to the brief aside on Mr. Damgard's products that we have, and do, face competition exactly in our products on a daily basis. Enron was but one of them.

However, giving them their due, the one benefit of Enron online was it provided a certain amount of market transparency, which doesn't exist any longer. So in some ways, we have lost some things. In other ways, it was just a bad company, an explosion waiting to happen. And I think that we can look in the context of accounting regulation, securities regulation, but I think to look at commodity regulation as the fundamental cause is not correct. I have testified before that I believe that there were some disclosure and self-regulatory items that could have been improved or done differently in the CFMA, and I still believe that. But I don't believe that those issues are of paramount importance as we sit here today and certainly don't justify any broad reopening and that the vast majority of the CFMA has been extremely positive for the reasons that we have all said: regulatory flexibility and the deterrence of a lot of enforcement oversight by the Commission.

Mr. MORAN. Do you believe that the fraud and abuse provisions are sufficient, that we are at the right regulatory stage in energy markets?

Let me ask it this way: the Modernization Act created the appropriate standard. Is that true or false?

Mr. WOLKOFF. I believe the way the Commodity Futures Modernization Act has been applied and interpreted by the CFTC makes it the appropriate standard. I think the CFTC has been appropriately assertive and aggressive in how it has interpreted the statutory language of the CFMA. I think without an aggressive CFTC, just reading the statute, you can pick and choose various phrases or words that might have been improved. However, the reality of it, as we sit here today, is the antifraud and anti-manipulation legislation is appropriate, is adequate, and is being reasonably enforced and well enforced by the CFTC and the various agencies of the U.S. Government.

Mr. MORAN. Mr. Wolkoff, thank you. As is usual, you answered the question much better than I asked it, and I appreciate that very much.

One of the advantages of being the chairman is that the red light has quit flashing while I am speaking, but I will give both Mr. Smith and Mr. Burns a second chance to ask questions.

Let me ask one on this topic of Mr. Pickel about legislation that is suggested pending mostly in the Senate on the issues related to California and energy. I want to give you the opportunity to make your position clear.

Mr. PICKEL. Well, we think that that legislation, that proposal, which of course was tabled last week in the Senate process, but is still being discussed, we understand, is flawed on any number of levels. First of all, I don't think that there is any evidence that OTC derivatives were involved in what occurred in California. I think I would agree with Mr. Wolkoff that there is clearly the regulatory authority as interpreted, as applied by the CFTC, to deal with some of the issues that did arise there. And they have taken enforcement action in a very deliberate and careful fashion, which I think it was interesting to hear Mr. Wolkoff confirm the view of the NYMEX. Of course, last year, when that legislation was considered, they were supportive of it, but at that time, the CFTC was very deliberately going through the process of understanding what occurred there and deciding what types of enforcement actions it should take. And now, in light of those actions, the NYMEX has indicated that they do not see a need for that legislation to pass.

There are any number of other issues. There are jurisdictional issues, the fact that this committee has not been as actively engaged in that process as well as the Agriculture Committee on the Senate side as well. There are jurisdictional issues regarding how the FERC and the CFTC are dealt with under that legislation. So on any number of levels from a policy perspective, from a jurisdictional, from a process perspective, we think it is fatally flawed.

Mr. MORAN. Thank you very much.

I would ask the Clerk to turn back the light on, and I will recognize Mr. Smith.

Mr. SMITH. He just knows me too well.

It is my impression that with the CFTC, the Commodity Futures Trading Commission, some of their muscle and spurs have been taken away with what some considered more aggressive oversight in the past. And it also is my impression that the expansion of trading after the CFTMA, there has been significant expansion and, I assume, an increase in profitability. How many owners are there in the Chicago Board of Trade and the Chicago Mercantile Exchange? And are there any single owners, individuals, as defined by IRS, that would own more than 20 percent of the business? Help the committee understand that a little bit.

Mr. CAREY. I can answer that more easily, because we are still a membership organization. I don't believe anybody owns 20 percent of our exchange, and we are not bound by the SEC. So no, we are still a membership organization, 1,402 regular members, and then there are various associate memberships that total altogether about 3,600 memberships.

Mr. SMITH. And are any of the trades on the board as far as being publicly traded?

Mr. CAREY. Well——

Mr. SMITH. Not the Chicago Board of Trade. You said no, it isn't. It is a membership.

Mr. CAREY. No, it is not. It is a membership organization.

Mr. SMITH. Are any of the trades, the Mercantile——

Mr. DUFFY. We are a publicly traded company, yes. We are the only one in the United States that is publicly traded.

Mr. SMITH. And have profits gone up because of the market or because——

Mr. DUFFY. The profits are up significantly for several reasons, and I think it has absolutely nothing to do with the enactment of the CFMA. It has got to do with fundamentals in the world economy. The Chicago Mercantile Exchange is there to manage risk for the world, and that is exactly what we do. We all have seen and have lived over the last several years what is going on in this world. And we have seen the volatile markets that we have all participated. Obviously, volatility is one of the drivers of our revenue, because it creates more trade. Volatility has been there, so we have increased our business, obviously, with the volatile markets.

So but I don't think it has anything to do with the CFMA. What the CFMA has done for us——

Mr. SMITH. But the CFMA, at least when we talked about it 4 years ago, part of the justification was to try to make sure that foreign markets didn't take away. We were to have better flexibility in attracting some of those businesses that were previously maybe going to those foreign trades, is that right?

Mr. DUFFY. Yes, I think so, but I mean, the CFMA, what it has done is it enabled for us to—originally, when we wanted to bring product to market, we had to go to the CFTC, and it took months. Now it can take up to 60 days is the maximum period. We went for the CFMA to get the prohibition lifted on the Shad-Johnson Accord so we could participate in the single-stock futures, which we do. We own 40 percent of OneChicago Exchange. We do now own a single-stock futures exchange. So the CFMA had extremely a lot of benefits to it, but our increase in volume is due to fundamentals.

Mr. SMITH. And Mr. Damgard, I don't know who else, are there any other of the future trades that are publicly traded?

Mr. DAMGARD. No, but I think they are contemplating that. The IPO that the Chicago Mercantile Exchange did about a year ago has been extraordinarily successful, and I think it must attract the attention of the other exchanges. I would disagree with Mr. Duffy. I think the CFMA dramatically lowered the cost of regulation for the exchanges, and that certainly is contributed to the profitability of exchanges. And I think that this committee deserves a lot of credit for that.

Mr. SMITH. Gentlemen, thank you all. Mr. Chairman, thank you.

Mr. MORAN. Mr. Burns.

Mr. BURNS. Thank you, Mr. Chairman. Again, I appreciate the opportunity just to get a little bit more information on how you did in certain issues.

I want to shift to self-regulated organizations and the move maybe in your marketplace to identify entities or associations that you would expect to act as SROs. How are those going to be established, and how are they going to be effective in their purpose in regulating the business that you are engaged in? Perhaps either, I guess, Mr. Carey or perhaps Mr. Duffy, you could address that?

Mr. CAREY. Congressman, if you could rephrase the question a little bit as far as the SROs are concerned?

Mr. BURNS. What entities or associations would you expect to act as SRO organizations, for example, in your market or perhaps the energy market?

Mr. DUFFY. Within the futures market, I mean just a tiny bit of background, all of the exchanges themselves are SROs. The National Futures Association is an industry-wide SRO that tends to regulate those companies and individuals that are not otherwise regulated directly by an exchange. The SRO concept has recently been given a new breath of life in the issue of price indexes for energy markets in that there has begun to show a real problem in the fact that many, many companies that are trading, say, in natural gas contracts no longer are reporting their prices to the price reporting agencies because of the fear of investigation and prosecution, a lack of safe harbor. And one of the issues now that is open and actually part of the energy bill is to create a new category of SRO, which will stand between the energy merchants reporting their transactions and the price reporting services, which are determining the indexes. And essentially, by requiring the energy merchants to report to the SRO, they would receive, in essence, a safe harbor for any type of investigation or fraud, because it would be the job of the SRO to assure that the prices being passed along to the index providers are bona fide transactions. So that is the newest and most innovative use of the SRO concept that would require a very small modification to the Commodity Exchange Act and therefore I am sure if it goes forward, you will see it again.

If I might just make one comment on the previous question of CFMA. I think that without—I agree with Mr. Duffy that of course business conditions, supply and demand do generally make it a successful year or an unsuccessful year for an exchange. And it has reduced to some extent the cost of regulation, although I have not really been aware of that as a real factor. We seem to spend and enormous amount of money on self-regulation. But where the CFMA has helped is in the introduction of products and services, such as new trading opportunities, new markets, over-the-counter clearing, those things have brought real profitability to the Exchange. But I would add also to Mr. Damgard's members who do clear the vast majority, if not the entire number of transactions on our Exchange, transactional opportunities, which are dollars and cents for the industry as well. It has been a real boon money-wise, revenue-wise, and profit-wise to us and to the FCM community that serves us.

I hope I have answered your question, Congressman.

Mr. BURNS. Mr. Damgard, do you have a position, and could you give some input on the future SROs?

Mr. DAMGARD. A number of my members have raised the question of whether or not when an exchange changes from a membership organization. And I think membership organizations were what the Congress had in mind when they wrote section 3 of the

Act for self-regulation, whether or not all of those functions that are currently housed with the Exchange continue to be appropriate. And we are gratified that Chairman Newsome has decided to do a review of whether or not each and every one of those self-regulatory functions continue to be appropriate. For example, the exchanges regard many of the firms as competition, because they are engaged heavily in the over-the-counter market, Mr. Pickel's markets.

And to the extent that the exchanges have the right to create their own rules and then find people in violation of those rules and assess fines, we think that there is a conflict of interest there. We also believe that the NFA has capability to do things that currently are being done by the exchanges, and we look forward to participating in that review. I know that the audit function that the exchanges perform is one that is, number one, costly to the Exchange, and number two, from time to time, a firm may not want to share its innermost secrets with somebody who regards them as a competitor in terms of what they are charging clients in the OTC market.

So there are issues with respect to how self-regulation should proceed, but in the past, I think that both the exchanges and the NFA have an extraordinarily fine record of self-regulation, and of course, all of this is subject to the oversight of the CFTC.

Mr. ROTH. Mr. Congressman, if I could just add that as an industry-wide self-regulatory body, obviously Chairman Newsome's inquiry is something that we have a deep interest in and look forward very much to working with him on. The inquiry that Chairman Newsome is making isn't really unique of the futures industry. The same issues are being discussed on the securities side and certainly in markets all over the world. And self-regulation, by its nature, comes from the marketplace itself. And I am sure that as the markets evolve, the self-regulatory process will evolve in a way that best serves the interests of the members and the industry and the public that trades there. And Chairman Newsome's inquiry is something that we look forward very much to cooperating with him on that inquiry. And I think that it is a timely inquiry and one that I am sure all of us will cooperate in every way we can.

Mr. BURNS. Thank you, Mr. Chairman.

Mr. MORAN. Just a couple of wrap-up questions from my perspective. First of all, I want to get the Exchanges to just mention briefly their concern about tax treatment 60/40 and any other concerns we ought to be aware of in the tax code that is important to you.

Mr. CAREY. Obviously, the 60/40 blend that you are referring to the repeal of section 1256 that was contemplated a few weeks ago is important. We were not here to really explain what it would mean to our industry and that this tax treatment came from a well thought out plan that was put in place, I think, in the early 1980's, around 1981. We are the only industry that can not enjoy capital gains, and our customers can't enjoy capital gains, so this mark to market 60/40 treatment for our risk takers is very vital to the industry. It is, we think, what is a fair treatment and to raise it without thinking of the consequences would have a ripple effect throughout the industry and could adversely affect the liquidity pools that currently exist.

Mr. MORAN. Then I am interested in the products that we have attempted to have joint regulatory oversight between the SEC and the CFTC, is that just inherently not possible?

Mr. DUFFY. It is inherently not good. One of the issues we have, obviously, and I think you are referring to, is our single-stocks, and we have tried to list these products. I mean, we believe, and I think it was the clear intent of the Congress not to have duplication of regulation, and that is exactly what we are seeing. The SEC has really come to the forefront on this, and they will not—it has made the burdens really difficult on us, as the owners of OneChicago, to list product. So we believe that no exchange is choosing the SEC as its primary regulator. So Congress directed that the primary regulator should be the regulator of the underlying—I am just trying to find it here, of the underlying exchange and the secondary regulator would assert its authority only in cases where the primary regulator failed or lacked authority. That is not something that we have seen, and we would appreciate that that could be brought to the forefront, because we are very concerned about this issue.

Mr. CAREY. Just to get our voice known, we generally agree with the Chicago Mercantile Exchange, and we would also look to Bill Rainer and OneChicago to assist us in the details.

Mr. PICKEL. Mr. Chairman, I think it is inherent. I think that they have different missions. And the SEC has always concentrated on customer/investor protection. And the CFTC, from the very outset, has had institutional users and has been much more concerned about protecting the marketplace. So those are things that are difficult to work through, but I think that, according to Jim Newsome, they are making some progress, and we look forward to more.

Mr. MORAN. Yes, sir, Mr. Gaine.

Mr. GAINE. Yes, Mr. Chairman. I see the problem with the single-stock futures, and I recall vividly several years ago arguing strongly before this committee and other committees to not touch the definition of security and pick up what is a futures contract. Exclusive jurisdiction should mean what it says. Unfortunately, my view was not the view of the Congress, as it ultimately turned out, but I think the dire predictions, unfortunately to a great extent, are proving true. But I mention that just to agree with the comments of the Exchanges, but to raise again the issue where we have public commodity funds that also are thoroughly vetted at the CFTC and/or the NFA by the experts who know how commodity markets work. And they have to register it under the 1933 Act of the Securities and Exchange Commission, and we have questions. And it is the same issue, but this one goes back 25 years. If anything could come out of the good is to get a respectful deference on a primary regulator concept or whatever, between the two agencies, whether it is single-stock futures or whether it is our public commodity pools, it would be of great benefit to the investing public in terms of efficiency and cost.

Mr. MORAN. All right. Mr. Gaine, I appreciate you taking the opportunity to say, "I told you so."

Mr. GAINE. This would be so foreign to me, Mr. Chairman.

Mr. MORAN. We were told. And I think there is inherent difficulties in trying to have dual jurisdiction.

Yes, sir.

Mr. ROTH. Mr. Chairman, if I could just mention, I sit here today as a representative of the world's only limited-purpose national securities association and that NFA is subject to regulation by both the CFTC and the SEC insofar as it pertains to our oversight of security futures products. And we have worked very closely with the CFTC and the SEC and the industry in developing the rules for single-stock futures, but certainly the process for anybody that is subject to regulation being subject to multiple regulators just compounds the problems. And we have had a good working relationship with all of our oversight agencies, and hope to continue to have one. But yes, there is just inherently, in the process, duplication of effort, and it makes the process more cumbersome.

Mr. MORAN. Let me just, to conclude, give any of you the opportunity to tell the subcommittee your conclusion about any suggested changes or—and here I speak about legislative changes, anything in particular that we ought to be thinking of as a result of the Modernization Act that needs to be addressed by Congress.

Mr. DAMGARD. We believe that the Act is in the process of being implemented and that it would be a mistake to open the Act to any kind of modification. We do believe that some of the issues that we have talked about with respect to the SEC and the CFTC could use some nudging from Congress with respect to solving those problems.

Mr. PICKEL. Mr. Chairman, I might add, this is not directly relevant to the CFMA and the CEA, but we continue to advocate the passage of amendments to the Bankruptcy Code and the Bank and Solvency Codes to confirm the coverage of netting under our contract, our master agreement, as well as other industry-wide mass agreements and repos and securities lending. We think that is an important piece of legislation. In my testimony, I mention that in the Enron bankruptcy, things went very smoothly as a result of bankruptcy laws that were in place then. But there is always the potential, in any bankruptcy, that someone may seek to get out of its obligations by relying on the fact that the Bankruptcy Code amendments have not been expanded as widely as we have advocated them. So I would urge you to support the legislation that would focus just on the financial netting provisions that are currently working its way through Congress.

Mr. MORAN. Thank you for the reminder.

Mr. DUFFY. I have been waiting a long time to say this. I completely concur with Mr. Damgard.

Mr. MORAN. On that note, I think it is a good time to adjourn our subcommittee. And without objection, the record of today's hearing will remain open for 10 days to receive additional material and supplementary responses from the witnesses to any question posed by a member of the panel. This hearing, after I thank you for your participation, I have discovered that the greatest gift anyone can give is their time, and you have been very generous, and we thank you for that. This subcommittee is adjourned.

[Whereupon, at 12:40 p.m., the subcommittee was adjourned.]

[Material submitted for inclusion in the record follows:]

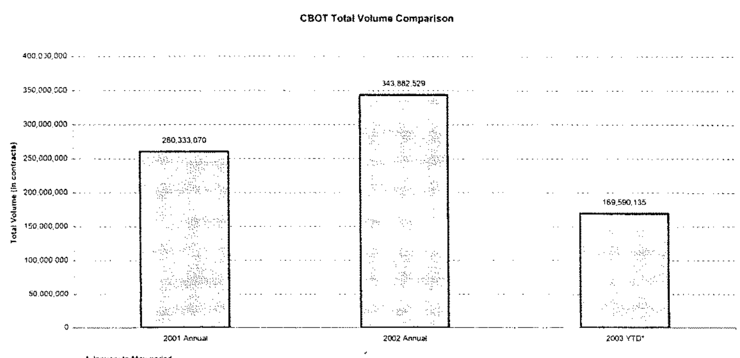
Mr. Chairman and Members of the Subcommittee, my name is Charlie Carey. This year on March 12 I was elected Chairman of the Board of Trade of the City of Chicago. I have served the Board of Trade in many capacities over the years, but this is my first term as Chairman and my first appearance before a congressional committee. I am joined this morning by Bernard W. Dan who serves as our President and Chief Executive Officer. Bernie has considerable experience in our industry and has assembled an outstanding management team to implement the strategic goals of our Board of Directors. We look forward to working with you and this Subcommittee. I would be happy to answer any questions you might have.

I am proud and honored to represent the Board of Trade's members. One hundred years ago my grandfather became a member of the Board of Trade. Both my grandfather and my uncle served the Board of Trade as Chairmen. You might say then that the Board of Trade is in my blood. I am very proud of that tradition.

Thank you, Mr. Chairman, for convening this oversight hearing on the impact of the Commodity Futures Modernization Act and other current issues of importance to the U.S. futures industry. Your interest and leadership are very much appreciated.

Board of Trade Update.

Before discussing the CFMA, I thought I should give you a snapshot of how our business has fared since enactment of that legislation in 2000. Our business is doing well and growing stronger. In 2001, the Board of Trade's total trading volume was 260.3 million contracts. That was then a record year. In 2002, the Board of Trade's total volume rose by 32.1% to 343.9 million contracts. Thus far, 2003 is also proving to be a record-setting year. Our total volume through May was 169.6 million contracts, an increase of 37% over the first five months of 2002.



Overall these figures reflect the confidence our customers have in our markets.

Other data confirm this conclusion. For May 2003, the Board of Trade traded 43.8 million contracts, an exchange record. We also set daily trading volume records on four days during the month. May average daily volume was over 2 million contracts, up 57.6 % from the level of a year ago. Our financial futures and options volume through May was up 41% from last year for the same five month period. And our agricultural futures and options volume through May was up 10% from last year.

A core element of our business plan has been the decision to offer customers both pit trading and electronic trading platforms. In contrast, most foreign exchanges offer only an electronic platform. We let the customers choose. How has that worked? To date, the evidence is that both pit and electronic trading attract customers and serve a customer need. For the first four months of this year, pit trading constituted 50.1% of our volume and electronic trading accounted for 49.9%. Almost all our agricultural contracts are traded in the pits and the majority of trades in our financial contracts are executed electronically. Yet through April of this year, over 40% of financial and equity trades at the Board of Trade were executed in the pits.

It is true that electronic trading has grown significantly in recent years and this year our electronic trading volume through May was up 112% thus far. But pit trading still remains viable and vital.

Like any business, while we are gratified by this increase in our volume, we know we face ever increasing competitive challenges. Before I describe our plans to enhance our ability to compete, I have a few observations to share with you about the CFMA.

The Commodity Futures Modernization Act of 2000.

The Board of Trade supported passage of the CFMA. Modernizing futures regulation, providing legal certainty for OTC derivatives transactions and opening the door to single stock futures trading were sound policy goals we were pleased to support. We realize that all legislation involves significant compromise. It is not surprising that we did not agree with every provision of that legislation. Nevertheless, it has had many positive results.

Since enactment of the CFMA, futures regulation has worked well. In large part that success is due to the efforts of the Commodity Futures Trading Commission under the strong leadership of its Chairman Jim Newsome. Chairman Newsome has struck an appropriate balance by making certain the CFTC's oversight of futures markets serves the public interest while not interfering with legitimate business decisions and activities. Most importantly, I believe Chairman Newsome has the respect of everyone in the futures industry for his fair judgment and constructive insight.

The CFMA was important for what it changed and didn't change. By ending the unwarranted ban on single stock futures, the CFMA led to the creation of OneChicago, the Chicago exchanges' joint venture in security futures products. The legislation has fostered other product and market innovations by allowing exchanges to list new contracts or change trading practices expeditiously to address new competitive realities. Just as significantly, these benefits are available only to trading facilities that have received the CFTC's seal of approval, designation as a contract market or registration as a derivatives transaction execution facility. Only those markets that the CFTC finds can be entrusted with all of the congressionally-defined, self-regulatory responsibilities are able to enjoy the benefits of the CFMA's innovation-friendly reforms.

Chairman Newsome has recently called for a review of self-regulation in the futures markets primarily in the context of the possible impact of ongoing market changes on market integrity. Strengthening market integrity is a goal every one should share. We look forward to working with Chairman Newsome and the Commission on this review.

Some misread the CFMA as if it allowed competition in the futures markets for the first time. I see it very differently. The futures markets have always faced open competition. Any CFTC-approved exchange has always been, and still is, free to compete with other exchanges by listing any legitimate product for trading (although some specific stock index products are subject to exclusive and appropriate private licensing arrangements). Foreign exchanges as well as over-the-counter markets also compete with our markets.

The Board of Trade knows that if we stop serving our customers well, we will lose our markets to these competitors. Other exchanges are always looking for market opportunities to trade our contracts or a similar product if we fail to deliver the required level of service. And we too are looking for those business opportunities, while also trying to identify new products we could offer the markets. To the extent this competition sparks desirable innovations, our economy is well-served.

Competition and the Board of Trade.

Competition seems to be the main theme of the industry debate today. I am known for being blunt. So let me put this bluntly. Those who would tell you that U.S. futures exchanges are monopolies and face no competition are completely out of touch with reality. There is more competition today than ever before.

The Board of Trade offers a unique rebuttal to the alleged absence of competition in the futures industry. Twice in the past five years, new exchanges were created to compete directly with us. Their general business plan was the same: copy the Board of Trade's U.S. Treasury Security contracts and offer an electronic marketplace for trading these products. Both exchanges were well-financed and well-positioned in the financial world. Both exchanges said they were the exchange of the future, the Board of Trade was antiquated and washed up.

What happened? Neither of the new exchanges has achieved its stated objective. Instead, the Board of Trade's U.S. Treasury Security markets have continued to serve the needs of our customers and enjoy record volume.

Why was the Board of Trade successful? In my opinion, we have the most cost-effective, reliable, fair, transparent and safe markets available. Our members provide the essential ingredient of market liquidity that makes spreads tight, order execution dependable and prices reflective of true economic conditions. As I mentioned before, we also offer our customers two trading platforms -- pit trading and electronic trading in an integrated format. Harnessing and harmonizing the advantages of both types of trading systems have served our markets well and, I believe, set our markets apart from others around the world.

As proud as I am of the Board of Trade's record of achievement, I know that existing and new competitors will continue to challenge us. I promise we will do whatever we can to continue to serve our customers to the best of our ability and to compete with anyone.

Two decisions by the Board of Trade this year show that I mean to keep that promise. In January of 2003, the Board of Trade decided to replace our current electronic trading platform with LIFFE CONNECT starting in January 2004. That decision was based on one overriding factor: after a careful evaluation of all alternatives, we believed the LIFFE CONNECT system offered the best trading platform for our customers and members today and in the future. It is robust, adaptable and offers the greatest prospect for growing our markets. We believe the LIFFE CONNECT platform will enable our members and customers to operate with greater ease and efficiency when trading in our electronic and open out cry auction markets. Standing pat with our current trading platform may have been the safe choice, but we wanted to be sure we were positioned to provide the best trading system available.

Second, on April 16, 2003, the Board of Trade announced a truly historic clearing link with the Chicago Mercantile Exchange. Again, we changed our clearing platform because doing so was best for our customers and members. Our clearing link will provide market participants with many of the market efficiencies they have been requesting for years.

The link is a win-win proposition. It will result in cost savings for market participants and clearing members, while strengthening financial integrity. Initial estimates suggest that market users can achieve substantial margin savings for interest rate and equity index products. This will make our markets stronger and more competitive.

Through these two decisions, we have expanded service to our members on two key fronts. Together the LIFFE CONNECT platform and the Common Clearing Link will fortify the Board of Trade's overall business objectives by building upon our core values of transparency, liquidity, flexibility and market integrity. These decisions are good for our customers, our members, our clearing firms, and our exchange. They also will serve to enhance the reputation of the City of Chicago as the risk management capital of the world.

New Exchanges, New Competition.

Technology and globalization have sparked competition among the U.S. and foreign futures exchanges for many years. Each has developed its own products and attempted to distribute those products around the world. As part of that competition, through the CFTC no-action process, foreign exchanges have been allowed to locate their trading terminals to allow U.S. firms and customers to trade on the foreign exchange. Thus far, this trading generally has been limited to products already offered by those foreign exchanges in their home country. Some have suggested that U.S. exchanges would not have the same ease of access for locating trading terminals in some other countries as foreign exchanges have here.

In recent months, the media has been reporting a possible significant change in this competition. At least one foreign exchange is exploring opening a U.S. exchange that it has said would offer many of the contracts currently offered by U.S. exchanges in an effort to become the dominant marketplace for trading those contracts. The CEO of that exchange's parent recently hailed its track record for "cross-border stealing of liquidity," and proclaimed that in this competitive business "the winner takes all." Any such foreign-owned U.S. exchanges would need to apply to and become designated by the CFTC.

The idea of foreign-owned U.S. exchanges offering U.S. products raises unprecedented public policy issues that go beyond the narrow competitive interests of any exchange. Our regulatory system, especially after the CFMA, is built on self-regulation. That system calls for exchanges, like the Board of Trade, to be aggressive first responders to emergency and other market disruptions that could undermine market integrity or other recognized public interests. The announced plans of at least one foreign exchange would contemplate, for the first time, allowing a foreign owner to control a U.S. exchange during a period of market turmoil that could have significant pricing consequences for major forces in our national economy, whether in the area of agricultural prices, U.S. government debt prices or others.

In the past, neither Congress nor the CFTC has had to consider whether such foreign ownership is compatible with the CEA's emphasis on self-regulatory organizations and the national public interests they must serve. The CFMA never dealt with this issue. In other areas of commerce -- including banking, telecommunications and aviation -- foreign ownership considerations have resulted in the adoption of special regulatory rules. To the extent the rumored business plans of foreign entities or exchanges present similar concerns, we are sure Congress and the CFTC will consider those issues carefully and fully.

Conclusion

Thank you for the opportunity to appear before you today. This is an exciting time for the futures industry. Exchange-trading of derivatives is in great demand world-wide. Despite the advances made by our foreign competitors, more futures and options contracts are still traded on U.S. exchanges than anywhere else in the world. The Board of Trade is proud to have played a leading role in helping to create this national industry. We look forward to building upon our past accomplishments by continuing to work diligently and aggressively to serve the needs of the marketplace today and in the future.

Testimony of
Terrence A. Duffy, Chairman,
Chicago Mercantile Exchange Inc.
to the
Subcommittee on General Farm Commodities and Risk Management
Committee on Agriculture
U.S. House of Representatives

Re: Implementation of the Commodity Futures Modernization Act of 2000

June 19, 2003

Thank you, Chairman Moran, and members of the Subcommittee. I appreciate the opportunity you have given me to testify on behalf of Chicago Mercantile Exchange Inc. I have had the honor to serve as Chairman of CME since April of 2002. This has been a time of growth and change for our exchange as it continued its steady evolution from its origins in 1874 as an agricultural traders club into one of the world's most innovative and high-tech financial exchanges. On Dec. 6, 2002, we completed our initial public offering and became the first publicly traded financial exchange in the United States--listing our stock on the New York Stock Exchange.

This has also been a very challenging political and economic period for our country and the world. In these uncertain economic times, we at Chicago Mercantile Exchange strive to fulfill the essential role of helping institutions, corporations and individuals around the globe efficiently manage their financial risk.

The CFMA: Successful landmark legislation:

In the judgment of the CME, the Commodity Futures Modernization Act of 2000 (CFMA) represents successful landmark legislation that materially and beneficially reformed some of the nation's most important financial markets. Our futures markets are substantially stronger and more vibrant today as the direct result of Congress' enactment of the CFMA and, equally importantly, the CFTC's judicious and deliberate implementation of those reforms. Innovation has been encouraged and made less costly and more rewarding. The time between conception of a new product or trading system and its implementation has gone from years to days. Today, the vast majority of CME's investment in innovation is for improvement and testing rather than paperwork and bureaucratic review.

I want to highlight some of our many achievements under the CFMA regime and indicate some important initiatives now under way by CME.

- During 2003, our volume continues to grow. So far in 2003, CME's average daily volume has increased more than 12% over the same period in 2002. During June thus far, our average daily volume has exceeded 3 million contracts, a healthy 43% increase from the 2002 average daily volume. Our open interest last week reached an all-time record of more than 25 million contracts. Open interest is the number of futures and options contracts outstanding at the close of trading each day and is a widely recognized indicator of the level of customer interest in an exchange's products. We are proud to have the largest futures and options on futures open interest of any exchange in the world.

- CME solidified its position as the largest futures exchange in the United States and the second largest exchange in the world for the trading of futures and options on futures, based on trading volume.

- GLOBEX® volume has grown from hundreds of contracts per day to more than one million contracts per day, while the open outcry trading floor continues to serve its core customers who prefer that trading venue.

- GLOBEX continues to grow, representing approximately 44 percent of our total volume in the first quarter of this year.

- CME's E-mini™ S&P 500 futures contract reached a new record of 116 million contracts in 2002, an increase of 194 percent from the prior year. Our E-mini S&P remains the fastest growing product in the history of CME.

The latest major development at CME is the recently signed definitive agreement with the Chicago Board of Trade to establish the CME/CBOT Common Clearing Link. Under this agreement, CME will provide clearing services for all CBOT products beginning on Jan. 2, 2004. We expect that CFTC's regulatory review will be efficient and expeditious, free of the time-consuming processes that would have been standard prior to CFMA. Naturally, we also expect CFTC to grant all regulatory approvals in order to maintain our targeted roll-out date of Jan. 2, 2004.

This historic transaction between the two largest futures exchanges in the United States will give our clearing firms and customers significant operational, margin and capital efficiencies. We are delighted to unite with the CBOT to offer the customers of our exchanges exactly what they have told us they wanted. By clearing CME and CBOT products through our Clearing House, we can offer extended portfolio margining. In other words, we will recognize the positions held at both exchanges and reduce performance bonds as appropriate: this exemplifies our efforts to provide value to our customers and shareholders at the same time. This new clearing agreement also signals CME's ability to provide transaction processing services to third parties.

The Common Clearing Link agreement with the CBOT is one of the many important items on CME's agenda, which includes several other important initiatives of which the Subcommittee should be aware:

- CME is focused on expanding the range of execution choices we offer our customers, including increased electronic trading. Our foreign exchange complex enjoyed great success in 2002. Trading was up 8 percent from 2001, with GLOBEX trading increasing 115 percent in this product line. In response to customer demand, on Jan. 26 of this year, we launched our Eagle Project, which enables implied electronic calendar spread trading of Eurodollar futures on GLOBEX.

- As a result of the rationalization of product introduction permitted by CFMA, CME is building on its heritage of innovation by adding new products and services to address current and emerging risk management needs. Innovation is a hallmark of this exchange, and our passion for innovation is as strong today as ever.

- In addition, we will continue to collaborate with our clearing member firms to ensure constructive dialogue and the pursuit of mutually beneficial industry growth opportunities. Specifically, we are focused on streamlining operations and increasing efficiencies to benefit our important FCM community that participates in our markets. To that end, we are diligently working on several fronts, including:

    - Cost reductions;
    - Straight-through processing and standardization;
    - Further improvements on GLOBEX; and
    - Collateral flexibility for our clearing member firms.

Our steady march from an agricultural-traders club to publicly traded financial institution is an achievement that has made our members and owners proud. But, more importantly, our new publicly traded status will help us achieve the key elements of our long-term business strategy. In that regard, I want to dispel a myth: We have heard that there are some observers, apparently including some government regulators, who have speculated that a for-profit business model creates pressures on exchanges to reduce their spending or staffing levels in regulatory areas. We strongly disagree with that notion. CME has always operated in a business environment that required us to make difficult spending and investment decisions among competing areas (e.g., between regulation, technology, new product and business initiatives, marketing, physical facilities and staffing, etc.). While we were a mutual membership-owned not-for-profit corporation, we maintained a strong commitment to funding our regulatory systems, programs, operations and staffing levels. In years when we have had significant budget pressures, we did not reduce our commitments to this important area because we believe it is an extremely important component of our overall success.

Rather than detracting from our ability as an effective self-regulator, CME's incentives and capability to maintain an effective program of self-regulation have been enhanced by its reorganization as a for-profit public company. The regulatory staff's independence and empowerment has been cemented by this new corporate structure and the reporting lines that have been implemented. CME is subject to the disclosure and reporting requirements imposed by the Securities Act of 1933 and by Securities and Exchange Commission regulations. CME's ownership base has been expanded to include institutional investors. Professional securities analysts who are unaffiliated with CME and/or its bankers follow every action of the company. Any failure to maintain and effectively implement prudential regulatory programs will cause these analysts and shareholders to adopt a negative view of our performance, and our stock price could decline. The scrutiny of these shareholders and analysts further ensure that we have sufficient inducement to maintain the effective regulatory programs that are so critical to our brand name and our success.

Single Stock Futures: CFMA's Unfulfilled Promise

The CFMA broke new and important ground in authorizing the trading of single stock futures. The discussions between the CFTC and the SEC with regard to the regulatory regime pertaining to single stock futures have taken a considerable amount of time, and we understand that the agencies believe they are coming to the end of that process. Undoubtedly the depressed state of the equity markets has contributed to the modest initial trading of single stock futures, but we believe that with a resurgent stock market, interest in single stock futures will materially increase. Overall, we remain confident that the CFMA's authorization of single stock futures was wise public policy, and the removal of legal prohibitions on that product was a significant positive development.

Nonetheless, we want to bring to the Subcommittee's attention what we consider to be a very important problem we have experienced in the initial efforts to bring single stock future products to market. If unaddressed, this problem threatens to undermine Congress' intent in the CFMA that exchanges not be burdened by duplicative regulation.

Our experience as a notice registered security exchange and our view of the regulatory burdens to which our joint venture, OneChicago[1], has been subjected, lead us to question whether the CFMA provisions respecting joint jurisdiction over exchanges that trade security futures products are being misapplied by the SEC. After a protracted effort to list a security futures product, CME withdrew its submission rather than subjecting itself to confusing and costly dual regulation.

This is not the venue in which to retell in detail this long story. In brief, Congress granted the CFTC and SEC jurisdiction over exchanges that list and trade security futures products, but clearly determined that an exchange's principal registration status should decide which agency should take the lead. In the case of CME and OneChicago, the CFTC is the primary regulator. The SEC has asserted authority that effectively puts it on a par with the CFTC and creates a system of active dual regulation contrary to the clear intent of Congress.

[1] OneChicago is a joint venture created by CME, Chicago Board Options Exchange and Chicago Board of Trade. It is a Designated Contract Market subject to CFTC jurisdiction and regulation and notice registered with the SEC.

SEC and CFTC negotiated an "abrogation" provision for use by the SEC based on a clearly expressed understanding that it was to be used only in dire circumstances after full review of exigencies by and a majority vote of the SEC Commissioners following consultation with the CFTC Commissioners. Congress mirrored this understanding in Section 19(b)(7)(C) of the '34 Act, which provides:

> "the Commission, *after consultation* with the Commodity Futures Trading Commission, may summarily abrogate the proposed rule change and require that the proposed rule change be refiled in accordance with the provisions of paragraph (1), *if it appears to the Commission* that such proposed rule change unduly burdens competition or efficiency, conflicts with the securities laws, or is inconsistent with the public interest and the protection of investors." (emphasis supplied)

It was expected that there would be no abrogation without Commission-to-Commission negotiation. Nonetheless, on August 20, 2001, without hearing, notice or prior publication the SEC delegated complete authority to its staff to abrogate rule changes of security futures exchanges that were primarily regulated by the CFTC. The SEC's delegation order included an explicit finding in accordance with Section 553(b)(3)(A) of the Administrative Procedure Act, "that these amendments relate solely to agency organization, procedure, or practice, and do not relate to a substantive rule." Yet, SEC staff has determined that the delegation was not ministerial—it transferred the SEC's power and authority to the staff. The delegation of authority to abrogate includes a delegation of authority to the Director of Division of Market Regulation to make the prerequisite statutory findings. The delegation of authority to abrogate implicitly includes the delegation of power to the Director of Division of Market Regulation to conduct consultations with the Commodity Futures Trading Commission. This delegation appears contrary to the understanding under which Congress permitted the SEC to retain such abrogation authority over security futures rules.

SEC staff has consistently asserted authority to rewrite the terms and conditions of new security futures contracts and the trading rules for such products based on its power to abrogate such rules if the exchange did not accede to all of the SEC staff's comments and "suggestions." A new contract cannot be launched if the potential for abrogation is in place. The SEC staff has converted its delegated abrogation authority into the power to act as the primary regulator with respect to the content of all new contracts and trading rules relating to security futures. The SEC is also in the process of taking over the review and oversight role of the CFTC by asserting the right to audit *all* functions of an exchange that trades security futures products.

Despite Congressional intention to permit exchanges to self-certify new contracts, the consequences of opening trading in the face of an abrogation threat are so severe as to give SEC staff de facto power to reinstitute a "pre-CFMA" regime requiring prior SEC approval of all rules and rule amendments. The SEC staff used threats of abrogation to impose wording differences for rules that would have created meaningless inconsistencies between CME rules for broad- and narrow-based index products — such as those for Final Settlement Prices. Such inconsistencies are likely to create confusion during emergencies (e.g., in 1999 when hurricane Andrew almost prevented the opening of the NYSE on triple witching day; in the immediate aftermath of 9/11/2001). The SEC staff threatens to abrogate new contract rules based on an economic model for speculative position limits for cash-settled futures that is untested, not public and that produces limits that are not rationally related to similar products' limits. The SEC staff frequently insists on non substantive changes that create inconsistent wording within the over all rule book and may cause confusion when rules that should have the same meaning and purpose are worded differently.

We cannot list and trade security futures products without recognition from the SEC and CFTC that the concept of "listing standard" does not include the terms and conditions of a contract and that the exemption from filing rules contained in CFMA Section 6(g)(4)(B) is operative. We also need assurance from the SEC and CFTC that the SEC will not duplicate the inspection and monitoring functions of the CFTC simply because a futures exchange lists a securities futures product as a Section 6(g) exchange.

Fixed-Income Futures: CFMA's Orphan

While we applaud the many improvements made by CFMA's re-write of the Shad/Johnson Accord and other major parts of the CEA, there is one area in which it was a step backward, or at best a step sideways. That is the areas of index futures on non-equity securities. The rules distinguishing between broad-based and narrow-based security indexes apply to all securities, but were drafted without clear consideration of the significant differences in size and trading velocity between equities and fixed income securities. The U.S. fixed income securities are not typically traded on organized exchanges, and their trading volume is significantly smaller than stock volume. CFMA does not distinguish between the two very different classes of securities with the result that the same criteria are applied in determining which cash instruments can be the basis for futures contracts.

It is almost universally accepted that exchange-traded futures and options are complementary to cash products, and can lead to significant improvements in transparency and liquidity in those cash markets. Market regulators are concerned about the lack of liquidity and transparency in U.S. fixed incôme markets and have made some efforts to improve the situation, with mixed success. Therefore it is tragic that the distinctions drawn for equity markets are a great deterrence to listing futures on indexes of corporate bonds, security-based swaps and other fixed-income-related instruments.

We urge Congress, the CFTC and the SEC to use all available means to remedy this situation.

Recent Issues Involving Importation of Cattle:

Country of Origin Labeling (COOL) is part of the 2002 Farm Bill. It will require, among other things, all meat sold at retail (grocery stores) to carry a label showing the country (or countries) in which the animal was born, raised, and processed. This labeling requirement becomes effective September 30, 2004, and retailers are subject to a $10,000 fine for each violation.

In response to these labeling requirements, retailers are holding their suppliers (meat packers & processors, among others) responsible for meeting these same recordkeeping and documentation requirements, and in turn the packers are holding their suppliers (livestock producers) responsible. While we are aware of the ongoing controversy among affected elements of the industry as to whether Congress should revisit COOL--perhaps delaying or modifying the provision or even repealing it--under the current circumstance, CME will need to bring our Live Cattle contract into compliance with COOL. However, proposed regulations will not be available until September 2003, and final regulations will not be available until sometime in early 2004 at the earliest, and possibly September 30, 2004 (the date the law goes into effect) at the latest. The October 2004 Live Cattle contract – the first one for which deliveries would be subject to COOL – is scheduled to be listed on September 2, 2003 – at least several months, and maybe a full year, before the final regulations become available. The long and uncertain "gap" between normal listing dates and final regulations means that if we chose to delay listing until there is certainty we would have few, or no, contract months listed for trading while we wait for the final regulations. Even in the best-case scenario – final regulations issued in January 2004 – there would be only 4 of the regular contract months listed for trading, versus the normal 7 months. In addition to these timing issues, there are several contract design issues that will need to be resolved, but this will be difficult without the final regulations and some indication about how the market will differentiate between certified and uncertified cattle and between purely domestic and imported cattle. Significant issues respecting deliverable supply may result.

A further complication is the possibility that COOL could be revised, postponed or rescinded between the time final regulations are issued (and CME contracts are listed based on those regulations) and September 30, 2004. This would cause the contract specifications to be totally out of sync with cash market practices, and likely require Emergency Action to correct the situation.

CME looks forward to working with the CFTC to come to the most efficient response to the several serious challenges raised by the COOL mandate. We will keep the Subcommittee informed on developments as we proceed.

New Concerns Not Addressed in the CFMA: Foreign Ownership or Control of a U.S. Exchange.

CME strongly supported the CFMA and its philosophy of expanding our opportunities to compete while simultaneously challenging us by permitting new market structures and easing barriers to entry of new competition. As much deliberation as Congress gave the CFMA over the several years preceding its enactment, no consideration was given to the question of foreign control of a U.S. based derivatives exchange. CME welcomes fair competition from all sources but is concerned that CFMA's lack of specific focus on foreign ownership may be taken as a signal that significant issues arising out of such control are irrelevant to the statutory standards for designation of a contract market.

For example, it is a legitimate concern that: 1) a foreign exchange that generates profits under a system that protects it from significant competition will use those profits to subsidize efforts to capture U.S. markets; 2) market entry would be by means of abusive practices such as payment for order flow; 3) foreign ownership could impair the effectiveness of CFTC's emergency authority—especially where the emergency results from the governmental action in the jurisdiction of the foreign owner; and 4) restrictions on trading by an exchange's officers or directors are of limited utility when such persons are foreign nationals beyond the reach of U.S. jurisdiction. Neither the CEA nor existing CFTC regulations even require a foreign company with more than 10% ownership of a U.S. exchange to meet any qualification requirements.

This list is illustrative, but by no means exhaustive. Where the issue of who owns the exchange raises legitimate and perhaps novel public policy issues, ownership becomes a material element of the application. Those public policy issues should be given due consideration by the Commission under the aegis of its public interest authority.

Conclusion:

The enactment of the CFMA has brought a wide variety of constructive and beneficial reforms to the regulation of America's derivative markets. The nation and all the market participants, including CME, are better off as a result of the CFMA. The CFTC has administered the CFMA responsibly, but new challenges remain to be addressed if the full promise of the CFMA is to be realized. We look forward to continuing to work with the Congress and the CFTC in finding appropriate answers to these challenges.

COMMITTEE ON AGRICULTURE
SUBCOMMITTEE ON GENERAL FARM COMMODITIES
AND RISK MANAGEMENT

REVIEW OF THE COMMODITY FUTURES MODERNIZATION ACT

STATEMENT OF JOHN M. DAMGARD, PRESIDENT
FUTURES INDUSTRY ASSOCIATION

JUNE 19, 2003

Mr. Chairman, members of the Subcommittee, on behalf of the Futures Industry Association (FIA), I appreciate the opportunity to appear before you today to discuss the impact of the Commodity Futures Modernization Act of 2000 (CFMA) on the derivatives industry, generally, and more specifically, on the Commodity Futures Trading Commission (Commission or CFTC). Our regular membership is comprised of approximately 40 of the largest futures commission merchants (FCMs) in the United States. Among our associate members are representatives from virtually all other segments of the futures industry, both national and international.

We want to congratulate you, Mr. Chairman, for scheduling these oversight hearings. The CFMA signaled a radical new approach to the regulation of the derivatives markets, by which Congress authorized the Commission to develop a regulatory program for multilateral transaction execution facilities that would be "tailored to match the degree and manner of regulation to the varying nature of the products traded thereon, and to the sophistication of the customer." It is important, therefore, that the subcommittee examine from time to time the progress that the Commission is making in implementing this program.

The CFMA, of course, had other equally important goals. Among them, the CFMA removed the 20-year prohibition on futures on individual securities and narrow-based securities index contracts and, in another radical departure, provided for the joint regulation of these products by the Commission and the Securities and Exchange Commission. In addition, this legislation sought to assure legal certainty for over-the-counter derivatives instruments. At the end of 2000, the aggregate notional value of over-the-counter swap transactions was approximately $40 trillion. Although the Commission had used its authority to exempt the vast majority of these transactions from its jurisdiction, the lingering legal uncertainty arising from the absence of a statutory exclusion had become untenable. Finally, the CFMA clarified the Commission's jurisdiction over foreign currency transactions traded over-the-counter. Continued subcommittee oversight in each of these areas is equally important.

We also want to congratulate Chairman Newsome, the other members of the Commission and the Commission staff for their efforts over the past two and one-half years in developing the regulations necessary to implement the myriad provisions of the CFMA. The CFMA placed enormous demands on the Commission. Its performance would be admirable in the best of times. The terrorist attacks of September 11 and the subsequent regulatory obligations required under the USA Patriot Act, however, placed a terrific strain on the Commission's resources, as they have on the government generally. The Commission has met every challenge. In the area of regulatory relief for intermediaries, in particular, the Commission has undertaken steps that should alleviate a number of the regulatory burdens that intermediaries have faced.

For example, just this past week, the Commission promulgated amendments to its rules expanding the ability of commodity trading advisors and other account managers to allocate by the end of the trading day the futures and options on futures contracts executed in one or more bunched orders entered on behalf of multiple clients. The amendments implement the recommendations of the *Recommendations for Best Practices in Order Entry and Transmission of Exchange-Traded Futures and Options Transactions*, an industry-wide study prepared by the National Futures Association and the Futures Industry Institute at the Commission's request. FIA staff and representatives of its member firms contributed numerous hours and resources to assist in the preparation of this study. The amendments strike an appropriate balance—modifying terms and conditions of the existing rule that have proved in practice to be unnecessarily cumbersome for futures industry participants, while maintaining procedural requirements that will permit the Commission and the several self-regulatory organizations to meet their responsibilities of assuring continued customer protection.

The Commission has also adopted amendments to its rules expanding the types of investments that FCMs and clearing organizations may make with customer segregated funds. As the Commission noted in adopting these amendments, the authorized investments will "enhance the yield available to FCMs, clearing organizations and customers, without compromising the safety of customer funds." A third rule replaced a Commission interpretation that had restricted the ability of US FCMs to hold customer funds outside of the US. Since many FCMs have international clients, these restrictions were proving to be particularly onerous. The new rule established standards that removed impediments to the efficient conduct of international futures activities, greatly enhancing the competitive position of US intermediaries.

FIA has been working with the Commission staff and encouraging regulatory reform on these matters for several years. In at least one instance, our efforts have extended more than a decade. We are delighted that, under Chairman Newsome's guidance, the Commission is addressing these and other issues that, in our view, will facilitate the use of the US futures markets.

FIA's Support for the CFMA

The fate of FIA, its members and the US derivatives exchanges are inextricably intertwined. FIA estimates that our members effect more than 90 percent of all customer transactions executed on US contract markets. Our twenty largest members, all US FCMs, bring customer business to US exchanges from the four corners of the world. Among them, these FCMs hold customer segregated funds—that is, funds held solely for trading on US futures exchanges—in excess of $51 billion, approximately 90 percent of all customer segregated funds held by US FCMs. The exchanges' success is our success.

We, therefore, share in the exchanges' pride in the tremendous growth these markets continue to experience. From 2001 to 2002, for example, volume on the Chicago Mercantile Exchange and the Chicago Board of Trade increased approximately 35 percent and 32 percent, respectively. Volume on both the Kansas City Board of Trade and the Minneapolis Grain Exchange increased by more than 25 percent. Of particular interest to this subcommittee, it is important to note that trading in agricultural commodities increased approximately 10 percent. Despite the focus on financial instruments, we should not lose sight of the fact that agricultural futures and options on futures contracts continue to serve price discovery and risk management functions that are vital to US agricultural interests.

Our belief in strong, competitive exchange markets led us to work closely with Congress, the Commission, and related industry groups, including the exchanges and associations represented at this table today, to assure enactment of the CFMA. We were, and remain, convinced that an underlying purpose of the Commodity Exchange Act (Act)—"to promote responsible innovation and fair competition among boards of trade, other markets and market participants"—could not be achieved unless the prescriptive regulatory structure that had so restricted an exchange's conduct was replaced.

We believe Congress shared our enthusiasm for competitive markets and fully anticipated that the regulatory reform it endorsed through the CFMA would encourage new entrants to apply for designation with the Commission as contract markets or clearing organizations. These entities would compete among themselves and with the existing exchanges for customer business based on products, quality of execution and cost. Although the vigorous rivalry that we had hoped for—and that we believe Congress anticipated in enacting the CFMA—has not materialized, we are pleased that a number of entities see an opportunity in the US that was not available before.

Our support of the CFMA extended to those provisions of the CFMA that would allow exchanges and clearing organizations to certify that their rules were in compliance with the Act. In the past, FIA had used the Commission's rule review procedures to challenge certain rules when we believed they were not in the best interests of our members and our members' customers. Under the self-certification procedures of the CFMA, we have lost this ability. (In those instances in which the exchange or clearing organization chooses to request the Commission to approve a rule, the standard of review is narrower than under the prior law.) Nonetheless, we took comfort in knowing that a critical core principal of the CFMA is the requirement that, "unless appropriate to achieve the purposes of the Act", designated contract markets and derivatives clearing organizations must "avoid (1) adopting any rule or taking any action that results in any unreasonable restraint of trade, or (2) imposing any material anticompetitive burden on trading". Therefore, if any action of an exchange or clearing organization appeared to violate this requirement, the Commission would be authorized to act.

Subject to the Commission's vigilant oversight, therefore, we concluded that the core principles set forth in the CFMA should be more than adequate to assure that the other purposes of the Act are met: (1) deter and prevent price manipulation or any other disruptions to market integrity; (2) ensure the financial integrity of all transactions and the avoidance of systemic risk; and (3) protect all market participants from fraudulent or other abusive sales practices and misuses of customer assets.

Competitive Clearing

One of the acknowledged benefits of competition, of course, is the opportunity to reduce costs for the consumer. In this regard, the futures industry has long recognized the benefits of common clearing in reducing the costs to FCMs and their customers, allowing FCMs and customers alike to make more efficient use of their risk management capital through portfolio margining and, no less important, allowing FCMs to better monitor and manage the risks their customers are assuming across markets. Common clearing, therefore, protects customers and serves the public interest by enhancing the financial integrity of the markets. Achieving this goal has been elusive. We came close in Chicago several years ago. We had reached a tentative agreement to establish an independent clearing organization, to be operated like a utility, that would be jointly owned and governed by its members and the exchanges. Unfortunately, a final agreement was never reached.

In the absence of an agreement on common clearing, FIA and its members began to explore alternatives that would provide, to the extent practicable, many of the same economic and risk management efficiencies. For a period last year, therefore, we were encouraging the adoption of a program we call "directed clearing." Directed clearing would have allowed an FCM or its customers to choose the clearing organization at which all of the customer's contracts would be cleared. In this manner, the customer and its clearing firm would be able to take full advantage of the benefits of portfolio margining.

Another advantage of directed clearing would be that it would let the market decide, based on quality of services, breadth of services and costs, which clearing organizations were best able to meet their customers' needs. This approach reflected our firm belief that the market, and not the government, should determine which clearing organizations—and which exchanges and FCMs for that matter—would succeed and which would fail.

This alternative was by no means perfect and, more recently, FIA has begun to examine another proposal that would allow FCMs and their customers to make more efficient use of their capital through portfolio margining across all markets. Through its Competitive Clearing Committee, FIA is reviewing the feasibility of establishing what we call a Centralized Capital Facility (CCF). CCF is an ambitious program that is designed to benefit both the public and the industry. By consolidating position information and centralizing performance collateral across clearing organizations, this facility would be an effective means of providing portfolio margining to clearing members and their customers. CCF would also reduce clearing member capital requirements through the realization of offsetting value of correlated positions and would consolidate performance bond and guarantee funds. Membership would be open to all FCMs that met specific capital, risk and credit criteria in CCF and would not be mandatory.

We believe the CCF is consistent with Congress's direction to the Commission to "facilitate the linking or coordination of derivatives clearing organizations registered under this Act with other regulated clearance facilities for the coordinated settlement of cleared contracts." Implementation of CCF would require the full cooperation of the exchanges and their related clearing organizations, and we look forward to the opportunity of discussing this proposal with the exchanges and clearing organizations at the appropriate time.

We cannot leave the topic of clearing without acknowledging the common clearing link that the Chicago Board of Trade and the Chicago Mercantile Exchange have announced. The Chicago Board of Trade and the Chicago Mercantile Exchange, in the aggregate, account for approximately 85 percent of all US futures exchange volume. Therefore, this initiative holds the promise of providing certain benefits for which we have long argued. To this end, we have advised the leadership of both exchanges that we stand ready to work with them to resolve the numerous questions that are certain to arise as the business and operations details of their arrangement are implemented.

We understand that the exchanges may ask the Commission to approve the rule amendments and other actions that they will take to implement their agreement. Because the proposal may have an impact on the markets generally, we would support that decision.

Security Futures Products

Since the enactment of the CFMA, FIA has continued to work with the Commission and the exchange community to implement both the spirit and the letter of its provisions. In particular, we devoted significant time and resources over a period of almost two years to assist in the development of regulations governing security futures products. As Chairman Newsome noted when he testified before the subcommittee earlier this month, creating a regulatory program that sought to meld the best of the Commission's regulatory program with that of the Securities and Exchange Commission (SEC) proved to be far more difficult than originally contemplated.

To protect the interests of our members as the two agencies struggled to develop a workable and balanced set of rules, FIA and the Securities Industry Association (SIA) established a joint Security Futures Committee, which met weekly to discuss business, regulatory, legal and operational issues that could impact the product. This committee offered to work with all of the exchanges that expressed an interest in trading security futures.

FIA facilitated dozens of initiatives to educate, inform and provide input to the industry, regulators and exchanges including:

- FIA/SIA supported moving to risk-based margin and set minimum margin on security futures at 20 percent instead of the proposed 25 percent. FIA prepared background papers on futures versus securities margin to educate participants from both industries as well as the regulators.

- FIA/SIA worked with regulators to ensure security futures held in futures accounts were not disadvantaged in any way including the use of futures style margining and account statements.

- FIA/SIA supported allowing fullest possible participation for notice-registered FCMs including joining The Options Clearing Corporation.

- Staff worked with legal, compliance and operations representatives from FIA divisions to review and prepare substantial written and oral comments on all security futures proposals including but not limited to disclosure documents, NQLX and OneChicago exchange rules and user and API agreements, and OCC, National Futures Association and NASD rules. We also prepared numerous formal comment letters to the Commission and the Securities and Exchange Commission.

- FIA held both a joint FIA/SIA conference and FIA workshops to help members understand the unique legal, compliance and operational aspects of these new products.

Launching security futures was an enormous and costly compliance undertaking for firms. Without the joint efforts of all industry participants, in coordination with the CFTC, SEC and the relevant futures and securities self-regulatory authorities, trading could not have been initiated in November 2002. Although volume on these markets has not been as robust as we would like, we recognize that a bear market is not an ideal time to introduce futures on equity securities. Nonetheless, we continue to believe that this is an important product that will grow over time.

As Chairman Newsome reported, the CFTC and SEC have not been able to agree on rules that would permit security futures products that are traded on foreign exchanges to be offered and sold to US customers. Consistent with the CFMA's purpose of promoting fair competition among boards of trade, we had assumed that necessary rules, regulations or orders permitting the offer and sale of foreign security futures products to US persons would be adopted contemporaneously with the rule authorizing security futures products on US exchanges.

The customers of US FCMs include pension plans, investment companies, endowments, hedge funds and other large money managers. These entities are free to engage in transactions in the international securities markets with few regulatory limitations and use broad-based foreign stock index contracts to manage the risks of trading in these securities markets. Risk management would be enhanced if they were able to use futures on individual foreign securities and narrow-based security index contracts. We request the subcommittee to encourage the commissions to act promptly to fulfill this congressional mandate.

Standardization

We also have been working with the exchanges on matters not directly related to the CFMA. For example, several of the exchanges and clearing organizations and, in particular, the Chicago Mercantile Exchange, have spent considerable time and effort in working with FIA's Information Technology Division to examine the lack of standardization of data and protocols in the futures industry. In a survey conducted last year, FIA found that a wide variety of data formats and communications protocols are being used in the industry. The lack of standardization is a significant obstacle to promoting cost savings and competition within the futures industry. Standardized message interfaces should also serve to promote clearing competition. We believe the desire to move toward standardization is stronger now than ever before. Implementing that standard, however, may be difficult, and we look forward to working with the exchanges to this end.

Review of Self-Regulatory Organizations

As the above discussion indicates, the futures industry is undergoing significant structural change. The impact of these changes on the markets and market participants is not clear. In this regard, therefore, we welcome Chairman Newsome's recent announcement that the Commission is planning to conduct a review of self-regulatory organizations with the goal of encouraging further the modernization of their rules and regulations. The review will give the exchanges and clearing organizations an opportunity to consider whether any structural changes may be necessary to meet their long-term interests and the interests of their customers.

In particular, we would encourage the exchanges and clearing organizations to review changes in their governance structures. Governance, of course, is the hot topic of the day. However, it is one that FIA has been discussing for several years. FCMs have argued for some time that their interests are not adequately represented on the boards of directors of various contract markets and clearing organizations. In particular, our members firmly believe that that governance of clearing organizations must be independent of the exchanges whose contracts they clear. Governance should be vested in the clearing organization's members and shareholders in proportion to the risk they are assuming.

Our views in this regard are consistent with those of the Group of 30. In a report on *Global Clearing and Settlement*, the Group of 30 noted:

> Where an institution is user-owned, the interests of shareholders and users are already likely to be substantially aligned, and representation of other important stakeholders such as end-user investors and issuers and the wider public interest can be achieved through appropriate appointments. Where nonusers have an ownership stake in a private institution, then additional, strengthened mechanisms may be needed to ensure users have appropriate representation. *This is vital where users have no or very limited choice of institutions from whom they can procure services.* [Emphasis supplied.]

We are also pleased that the Commission intends to begin a review of the roles, responsibilities, and capabilities of self-regulatory organizations in the context of the market changes that have taken and are taking place. The potential for conflicts of interest, of course, is present regardless of its legal structure of the exchange or clearing organization. For example, since many exchange member firms are also active in the over-the-counter derivatives markets, all exchanges exercise self-regulatory authority over entities with which they believe they are competing for business. We also appreciate that the potential for conflicts of interest is not reduced when an exchange demutualizes. In fact, it might increase.

Legal Certainty for Over-the-counter Derivatives

In closing, we would like to comment on the provisions of the CFMA intended to promote legal certainty in over-the-counter transactions. As we all know, this was a driving force of this legislation. In a November 1999 report, *Over-the-Counter Derivatives Markets and the Commodity Exchange Act*, the President's Working Group on Financial Markets (PWG) recommended a number of amendments to the Commodity Exchange Act designed to remove the "cloud of legal uncertainty [that] has hung over the OTC derivatives markets in the United States in recent years, which, if not addressed, could discourage innovation and growth of these important markets and damage US leadership in these markets by driving these transactions off-shore." The CFMA's success in this regard is clear. The over-the-counter derivatives markets have continued their phenomenal growth. At the end of 2002, the notional value of all over-the-counter swap transactions exceeded $100 trillion, an increase of approximately $40 trillion from year-end 2000.

We recognize that the problems that came to light in the energy markets in 2001 have caused certain members of Congress to propose legislation that would result in the regulation of these markets. We joined the ISDA and other major financial industry trade associations in opposing this proposed legislation. The PWG also opposed this legislation and, as recently as last week, the PWG reaffirmed its position. We agree with the opponents that the pending would create legal uncertainty within the over-the-counter derivatives markets and unnecessary jurisdictional confusion between the Commission and the Federal Energy Regulatory Commission (FERC). We also agree with Chairman Newsome that this committee should determine whether any changes in the Commodity Exchange Act are warranted and only after careful consideration of the potential effects of such change. Chairman Newsome is correct that even small changes in the law can have a significant impact on the over-the-counter markets. We believe the separate administrative actions recently filed by the CFTC and FERC demonstrate that these agencies have sufficient enforcement authority to investigate and punish those market participants that choose to violate the law.

Again, Mr. Chairman, I want to thank you and the members of the subcommittee for inviting me to appear before you today. The futures markets are prospering in the United States, and we are committed to their continued success. We look forward to watching the new developments in the markets and the continued implementation of the CFMA. In this regard, when we next appear before you, we hope to be able to report that the vigorous competition that Congress anticipated in enacting this legislation has become a reality.

Testimony of John G. Gaine, President, Managed Funds Association Before the General Farm Commodities and Risk Management Subcommittee of the House Committee on Agriculture United States House of Representatives
June 19, 2003

Mr. Chairman and members of this Subcommittee, my name is John G. Gaine and I am the President of Managed Funds Association ("MFA"). MFA appreciates the opportunity to provide testimony for the Subcommittee's review of the Commodity Futures Modernization Act of 2000 (the "CFMA").

MFA is a national trade association, with approximately 700 members, that represents the managed futures, hedge fund, and fund of funds industry. MFA's membership is comprised primarily of commodity trading advisors ("CTA"), commodity pool operators ("CPO"), hedge fund, and fund of funds managers who manage a majority of the estimated $600 billion invested in managed futures and hedge fund investment vehicles worldwide. Of that $600 billion, a significant portion is managed by firms that are registered as CPOs or CTAs.

Many of MFA's members act as purchasers of futures industry services and, thus, are the indirect beneficiaries of market protection provisions of and rules promulgated under the Commodity Exchange Act (the "CEA"). Those sections of the CEA and the activities of the Commodity Futures Trading Commission (the "Commission" or "CFTC") that oversee the functioning of, or participation in, futures markets have an important impact on CPOs, CTAs, and their clients. Furthermore, many aspects of the business operations of MFA's members are subject to CFTC oversight under the CEA and, pursuant to delegation of certain regulatory functions under the CEA, regulation by the National Futures Association ("NFA")—the industry's self-regulatory organization. The Commission rules regulate the business activities of CPOs and CTAs through registration, disclosure, anti-fraud, record keeping and reporting requirements. The NFA regulates the sales, promotional, registration and operational activities of these entities. Each of the exchanges also regulates trading activities on their markets.

Many of MFA's members are regulated by a host of other federal agencies as well. The public offer and sale of interests in commodity funds are subject to the Securities Act of 1933 (the "1933 Act")—requiring registration of these interests and mandating disclosure obligations, the Securities Exchange Act of 1934—requiring the filing of certain publicly-available reports, and each of the 50 states' securities laws. Moreover, hedge funds are subject to Securities and Exchange Commission ("SEC") rules governing private offerings, large position reporting, anti-fraud and anti-market manipulation. All fund managers are subject to the anti-fraud provisions of the Investment Advisers Act of 1940 ("Advisers Act"), and certain managers choose to register as investment advisers with the SEC under the Advisers Act.

MFA's members will also be subject to the requirements of the USA PATRIOT Act of 2001 in the area of anti-money laundering, due diligence, and customer identification procedures. The U.S. Department of the Treasury has proposed regulations, pursuant to the USA PATRIOT Act, that would be applicable to CPOs, CTAs, hedge funds, commodity funds, and investment advisers and would require these individuals or entities to establish anti-money laundering programs. This is a description of just some of the significant regulatory oversight to which commodity funds, hedge funds, and their managers, are subject.

MFA, as an association, has evolved as the alternative investment industry has evolved. Until 1997, we were known as the Managed *Futures* Association. Until that time, our members were primarily CPOs and CTAs. Over the years, certain of these commodity traders began applying their futures trading strategies to other financial instruments and some of these futures funds have evolved into some of the largest "hedge funds." As our membership began to represent both managed futures funds and hedge funds, in 1997 we appropriately changed our name to Managed *Funds* Association.

Over the past year, alternative investments, particularly hedge funds, have received a great deal of attention by regulators, legislators, investors and the media. Apart from our efforts in working with the CFTC over the past few years on new rulemakings, which I will discuss below in more detail, we have been closely working with the SEC in its fact-finding mission covering the hedge fund industry that began in May 2002. Last month, I had the opportunity to participate in the SEC's "Roundtable on Hedge Funds" along with other distinguished panelists, including SEC and CFTC Commissioners and senior staff, that have an interest in this industry. The Roundtable was an excellent opportunity for the hedge fund industry to debunk many of the myths surrounding it, such as the notion that this segment of the financial world is "unregulated" or "lightly regulated." In fact, over half the managers of the world's 100 largest hedge funds are regulated by the NFA. Of those remaining, a significant number are managed by SEC-registered investment advisers. As was made clear at the Roundtable, hedge funds are subject to a host of regulatory requirements, including the anti-fraud and anti-manipulation rules of the SEC and CFTC.

In responding to the increased attention alternative investments have received in Washington, DC, MFA has been a vocal advocate for sound regulation of this important sector of the financial world—a sector that provides many benefits to the global marketplace. Hedge funds, as do commodity pools, seek to provide investors with an investment opportunity that is not highly correlated with more traditional stock and bond investments. These vehicles provide much needed liquidity to the commodity markets, particularly agricultural markets, which serves to increase the efficiency of the price discovery and hedging functions served by these markets. However, there remain barriers to entry into the futures markets created by the regulatory framework. We believe the CFTC's efforts at reducing unnecessarily burdensome regulations, as a result of the CFMA, will encourage greater use of futures products in the financial marketplace. Accordingly, we are delighted to be here today to discuss the impact of the CFMA on the managed funds industry.

MFA's Response to Industry Developments

In recent years, MFA has adapted to the changes and demands placed upon the industry through the promotion of various best practices guides for fund managers. Committee members may recall that in 1998, after the near-collapse of Long Term Capital Management ("LTCM"), both the public and private sectors focused upon ways to reduce systemic risk. In 1999, one notable public sector response was the report published by the President's Working Group on Financial Markets (consisting of the Secretary of the Treasury and the Chairpersons of the SEC, the Board of Governors of the Federal Reserve System, and the CFTC) entitled, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management" (the "PWG Report"). The PWG Report recommended a number of measures, both public and private, designed to enhance market discipline in constraining excessive leverage, recognizing that "[a]ny resort to government regulation should have a clear purpose and should be carefully evaluated in order to avoid unintended outcomes." Rather than proposing any direct regulation of hedge funds, the PWG Report's recommendations called for "indirect regulation" of unregulated market participants. One of the responses to this recommendation was the publication of "Sound Practices for Hedge Fund Managers," in February 2000, by the hedge fund industry.

MFA believes that the public and private sector measures implemented in the aftermath of LTCM, such as those described in the "Sound Practices for Hedge Fund Managers," have successfully reduced the exposure of global financial markets to systemic risk. Consequently, MFA does not believe that new regulation to address this risk is necessary, but does believe that we have helped foster one of the goals of the CFMA, as highlighted below, of reducing systemic risk. In light of the recent growth and evolution of the hedge fund industry, MFA is currently updating the "Sound Practices" document so that it continues to provide useful and timely guidance to hedge fund managers.

After passage of the USA PATRIOT Act in October 2001, before any rules were proposed for the hedge fund or commodity futures industry, MFA worked to publish its "Preliminary Guidance for Hedge Funds and Hedge Fund Managers on Developing Anti-Money Laundering Programs" in early 2002. The "Preliminary Guidance" serves as a handbook for fund managers seeking to meet the new requirements which are to be imposed in the area of anti-money laundering. Both the "Sound Practices" update and the "Preliminary Guidance" are two clear examples of MFA's work to respond to the goals of Congress and regulatory agencies in promoting the integrity of financial markets and their participants.

The Goals of the CFMA

I testified on behalf of MFA before this Subcommittee in support of the bill that became the Commodity Futures Modernization Act. MFA continues to be a strong supporter of the goals of the CFMA. Its passage in December 2000 represented a major and very positive legislative accomplishment that set the groundwork for regulations governing today's futures industry and which will be responsible for promoting the growth of this industry. As stated in the legislation itself, the goals of the CFMA, among others, are:

- to promote efficiency and accountability in the commodity futures industry;
- to streamline and eliminate unnecessary regulation for the commodity futures exchanges and other entities regulated under the Commodity Exchange Act;
- to reduce systemic risk and provide greater stability to markets during times of market disorder by allowing the clearing of transactions in over-the-counter derivatives through appropriately regulated clearing organizations; and
- to enhance the competitive position of United States financial institutions and financial markets.

The CFMA also mandated that the CFTC deliver its "Report on the Study of the Commodity Exchange Act and the Commission's Rules and Orders Governing the Conduct of Registrants Under the Act." Part of this report, submitted to Congress in June 2002, included a study of intermediaries—such as CPOs and CTAs. We believe that the objectives of the CFMA are in the process of being realized by the Commission, in accordance with the findings of this study, and through the CFTC's recently-adopted and proposed regulatory reforms.

CFTC's Review of Intermediaries

Today, this Subcommittee is reviewing the status of the CFMA. As part of this process, MFA would like to provide this Subcommittee with current CFTC developments in which MFA has been directly involved. As mentioned above, the CFTC submitted its report on intermediaries in June 2002. This Report primarily addressed proposed amendments to Commission rules governing futures commission merchants ("FCM") and introducing brokers as well as CPOs and CTAs. In this regulatory review, the Commission has been responsive to the competitive challenges facing the U.S. futures industry participants, while at the same time preserving important customer protections and market safeguards.

As required under the CFMA, the CFTC solicited views of the public, registrants, and the registered futures association with respect to potential regulatory reforms. Throughout this process, MFA has had the opportunity to work with the staff of the Commission to help it realize the goals set forth in the CFMA—particularly with respect to issues that are especially important to our CPO and CTA members. We have also worked closely with the Futures Industry Association, the National Futures Association, and various commodity exchanges in this process. MFA facilitated numerous meetings with CFTC staff members, provided its views on various proposed rulemakings through comment letters, participated in two roundtable panels that were part of the CFTC's study of intermediaries, and proposed a new regulation for adoption by the Commission. MFA applauds the work of the Commission in producing the 2002 report and its subsequent progress to date on regulatory reforms.

During the last CFTC Roundtable in September 2002, I served as a panelist on behalf of MFA, along with other members of the managed funds industry, to discuss prevailing issues on the regulation of intermediaries. As part of this debate, MFA strongly advocated a number of improvements to the regulatory regime governing the futures industry. This debate included discussion of the full implementation of single stock futures trading and the need for harmonization of the regulation of public commodity pools between the SEC and the CFTC. Some other ideas that were debated included the differing definitions of "client" by the SEC versus that of the CFTC, disclosure document delivery rules for CTAs, and additional registration exemptions for CPOs and CTAs, including one proposed by MFA. These discussions have borne significant results. In March of this year, the Commission proposed, and, hopefully, seems poised to adopt, significant rule amendments concerning the registration and business practices of CPOs and CTAs. I will discuss a few now.

2002-2003 Proposed Rulemakings

Registration Exemptions for CPOs and CTAs. For over a year, MFA has been working with the Commission on a proposed exemption from registration for CPOs that is based upon the presumed sophistication of the pool's investors. Currently, there is a mandatory requirement for registration as a CPO if a pool operator trades futures and options contracts on a futures exchange—even just one contract. Hedge funds, which are required to limit their offer and sales to institutional and individual investors that meet certain minimum income and net worth standards, must register as CPOs if they utilize futures contracts. Depending on the number of investors in a hedge fund, these investors must generally be either "accredited investors" defined in Regulation D of the 1933 Act, or "qualified purchasers" as defined in section 3(c)(7) of the Investment Company Act of 1940 (the "ICA").

Last year, MFA submitted a proposal for a new exemption from CFTC registration for operators of pools offered and sold only to certain sophisticated persons in private transactions exempt from registration under the 1933 Act (the "MFA Proposal"). This rule, proposed for rulemaking by the Commission on March 17, 2003, would provide an exemption for CPOs that sell only to: (1) individuals that are "qualified eligible persons" ("QEP") under CFTC Rule 4.7(a)(2), which includes the "qualified purchaser" definition under the ICA, and (2) institutional investors that are "accredited investors" defined under Regulation D or that meet any of the Rule 4.7 definitions of a QEP. MFA believes that this new exemption, to be codified as CFTC Rule 4.13(a)(4) would do the most to advance the goals of the Commission by reducing unnecessary and burdensome regulatory requirements imposed upon managers of commodity pools comprised of highly qualified investors. If the MFA Proposal is adopted by the CFTC, and we are optimistic that it will be, we believe that this will lead to greater use of financial and commodity futures products in the financial marketplace. Many private pooled investment vehicles avoid using commodity futures in their trading strategies because of the associated CPO registration requirement. The MFA Proposal would eliminate this requirement for certain funds and would encourage growth of the futures industry. We are pleased that the Commission has proposed this rule for adoption. The MFA Proposal has received numerous letters in support of its adoption.

Similarly, the National Futures Association has proposed a similar registration exemption for fund managers that engage in limited commodity interest trading. Historically, no such "*de minimis*" exemption has been recognized by the CFTC for operators of funds. NFA has proposed the creation of such an exemption (the "NFA Proposal"), to be codified as CFTC Rule 4.13(a)(3), to provide a CPO registration exemption for fund managers that: (1) engage in only a "de minimis" amount of futures trading, under one of two alternative quantitative constraints, and (2) sell only to accredited investors. MFA also supports the adoption of this rule.

The benefit of both of the MFA and NFA Proposals is that each is available on a pool-by-pool basis. Thus, a CPO may operate some pools on a regulated basis and other pools pursuant to either one of these exemptions. MFA is optimistic that these proposals will be adopted as final rules.

Bunched Orders. MFA has also supported and provided comments on recently-approved amendments to CFTC Rule 1.35(a-1)(5) regarding "bunched orders". This rule allows certain account managers to bunch customer orders for execution and to allocate them to individual accounts at the end of the day. The amended rule expands the eligibility of bunching to all customers and simplifies this process for account managers and FCMs. This is another area of reform on which MFA has been working with the CFTC for a number of years. MFA believes that allowing all customers to have their orders bunched will lead to better execution and pricing of their orders. We believe that this rule strikes the appropriate balance between achieving the Commission's regulatory objectives of protecting customers whose accounts are bunched, and reducing the unnecessarily burdensome regulatory demands placed upon account managers or FCMs that use bunched orders.

Definition of "Client". Another proposed CFTC rule concerns a topic that was greatly debated at the last CFTC Roundtable: the differing approaches between the SEC and CFTC in defining the term "client" for certain registration exemptions for investment advisers and CTAs, respectively. Under current CFTC rules, CTAs can generally be exempt from registration with the CFTC if they: (1) have not furnished commodity trading advice to more than 15 "persons," and (2) do not hold themselves out to the public as a CTA. The SEC has a similar exemption for investment advisers under section 203(b)(3) of the Advisers Act. SEC Rule 203(b)(3)-1 defines a single "client" to include a legal entity, such as a partnership, in meeting the "fewer than 15" limit. The SEC approach does not "look through" the entity and count individual partners or shareholders. Conversely, under the current CFTC approach , where the "person" (or client) is a legal entity, the CFTC "looks through" the entity and counts individual owners for the purposes of meeting the "15 or fewer" test. Under a proposed modification to CFTC Rule 4.14(a)(10), the Commission now seems poised to adopt the approach used by the SEC in counting a legal entity as one person. We are pleased the Commission has proposed to adopt the SEC approach. The proposed CFTC rule change will make this CTA registration exemption available to a greater number of CTAs.

Other Proposed Rules

MFA also supports a number of other rules that we believe are important to improve the regulatory structure governing CPOs and CTAs. The first relates to the document delivery requirements for CPOs and CTAs. The CFTC is now proposing to eliminate the requirement that a disclosure document be provided to a prospective pool participant prior to soliciting that participant, by amending CFTC Rule 4.21(a). Prior to issuing this proposed rule, the Commission had amended its rules to allow CPOs to use a profile disclosure document for solicitation purposes. Under the currently-proposed Rule 4.21, CPOs only have to provide the disclosure document by the time it delivers to the prospective participant a subscription agreement for the pool, so long as any material distributed in advance of such delivery is consistent with the final disclosure document. A similar rule for CTAs has also been proposed. All solicitations to prospective clients by CPOs and CTAs would still be subject to all relevant CFTC, NFA and securities regulations.

A second proposed rule concerns the elimination of duplicative document delivery requirements for operators of master feeder funds. Under the proposed amendments to Rules 4.21 and 4.22, the CFTC is removing the needlessly burdensome requirement that these operators deliver required reports to themselves for the other pools managed by them. A third, and final, proposed CFTC rule that I will mention would expand the CPO registration exemption available for "small pool operators." The proposed rule would double the limit on pool size, from $200,000 to $400,000, for which an entity can avail itself of this exemption.

Conclusion

MFA strongly endorses the CFTC's recent undertakings to fulfill the CFMA's mandate to enhance the competitiveness of U.S. futures markets and streamline their regulation. In particular, MFA supports the various rule proposals and amendments that I have mentioned and looks forward to their adoption in the near future. In addition, MFA hopes that the CFTC will continue to implement the CFMA's goals by undertaking to harmonize the SEC and CFTC rules governing public commodity pools, and to foster the full implementation of single stock futures trading. Overall, MFA believes that the Commission has demonstrated its willingness to solicit and actively consider suggestions and proposals by industry participants that will lead to greater modernization, efficiency and innovation of the futures industry. Accordingly, I look forward to answering any questions you might have. Thank you.

PREPARED STATEMENT OF
ROBERT G. PICKEL
EXECUTIVE DIRECTOR AND CHIEF EXECUTIVE OFFICER
INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC. (ISDA)
BEFORE THE
SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND RISK MANAGEMENT
COMMITTEE ON AGRICULTURE
UNITED STATES HOUSE OF REPRESENTATIVES
JUNE 19, 2003

Mr. Chairman and Members of the Subcommittee, I appreciate your invitation to testify on behalf of ISDA. We have appeared frequently before the Subcommittee in prior years and we welcome the opportunity to be with you today as you continue your important oversight hearings with respect to the Commodity Futures Modernization Act of 2000 (CFMA).

I.
Overview

ISDA is an international organization, and its more than 600 members include the world's leading dealers in swaps and other off-exchange derivatives transactions (OTC derivatives). ISDA's membership also includes many of the businesses, financial institutions, governmental entities, and other end users that rely on OTC derivatives to manage the financial, commodity market, credit, and other risks inherent in their core economic activities with a degree of efficiency and effectiveness that would not otherwise be possible.

The CFMA was adopted by Congress with broad bipartisan support after careful consideration over several years by four Congressional Committees and with the support of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission and the Chairman of the Commodity Futures Trading Commission (CFTC). The CFMA sought to modernize the Commodity Exchange Act (CEA) by providing regulatory relief for the futures exchanges, ensuring legal certainty for OTC derivatives, and removing the ban on single-stock futures trading.

ISDA's principal interest in the CFMA is with respect to those provisions of the legislation intended to provide legal certainty for OTC derivatives. The phrase "legal certainty" means simply that the parties to an OTC derivatives transaction must be certain that their contracts will be enforceable in accordance with their terms. As discussed more fully in Part II of this Statement, the CFMA framework for providing legal certainty is based on a long-standing consensus among Congress, the CFTC and others that OTC derivatives transactions generally are not appropriately regulated as futures contracts under the CEA.

The legal certainty provisions of the CFMA were intended by Congress both to reduce systemic risk and promote financial innovation. Our experience over the past several years indicates that both of these objectives have been achieved. Market survey data released by ISDA in April 2003 indicates 92 percent of the world's largest businesses use OTC derivatives for risk management purposes and that 94 percent of the 196 U.S. companies included in the survey do so. Moreover, the use of OTC derivatives to hedge interest rate, foreign currency and credit default risks has increased substantially in the last two years, evidencing the importance of OTC derivatives as a tool to manage risk in periods of economic downturn and uncertainty. As Federal Reserve Chairman Alan Greenspan noted before the Senate Banking Committee on March 2, 2002, OTC derivatives "are a major contributor to the flexibility and resiliency of our financial system." The reduction in systemic risk resulting from the use of OTC derivatives was also evident in the energy markets following the collapse of Enron in 2001. Indeed, it appears that the legal certainty provisions of the CFMA and the related provisions of the Bankruptcy Code (adopted by Congress in 1990) may have enhanced the ability of market participants to deal effectively with events such as the collapse of Enron.

The reductions in systemic risk resulting from enactment of the legal certainty provisions of the CFMA have not come at the expense of financial innovation. New types of OTC derivatives have gained increased market acceptance since enactment of the CFMA. For example, the significant growth in credit default swaps to manage credit risk in times of volatility and uncertainty has been greatly enhanced by the legal certainty provisions of the CFMA. Similarly, businesses ranging from ski resorts to beverage producers have begun to use weather derivatives to hedge the risk of adverse climate conditions on their businesses. Again, the legal certainty provisions of the CFMA have encouraged dealers to develop, and businesses to use, an increasing range of new kinds of OTC derivatives to manage additional types of risk. Finally, the legal certainty provisions of the CFMA removed the regulatory barriers to clearing with respect to OTC derivatives and, while collaterized transactions remain more prevalent, clearing proposals have been advanced recently and the emergence of these proposals attests to the positive effects of the CFMA on financial innovation.

For these reasons, ISDA shares the view expressed by CFTC Chairman Newsome to this Subcommittee earlier this month that the CFMA was "the right legislation at the right time." In this connection ISDA believes that the CFTC deserves commendation for the evenhanded manner in which it has interpreted and administered the CFMA in accordance with Congressional intent, as well as for its vigorous program of enforcement following the collapse of Enron and the California energy situation.

The legal certainty agenda is not complete despite the historic advances embodied in the CFMA. Specifically, Congress still needs to complete action on the financial contract netting provisions contained in the pending bankruptcy reform legislation. These provisions have broad bipartisan support, have passed the House on multiple occasions without opposition, reflect years of work by the President's Working Group on Financial Markets and include much needed improvement to the payment risk reduction and netting provisions of the Bankruptcy Code and the bank insolvency laws.

II.

Development of the Legal Certainty Consensus

Importance of OTC Derivatives

OTC derivatives are powerful tools that enable financial institutions, businesses, governmental entities, and other end users to manage the financial, commodity, credit and other risks that are inherent in their core economic activities. In this way, businesses and other end users of OTC derivatives are able to lower their cost of capital, manage their credit exposures, and increase their competitiveness both in the United States and abroad. Almost all OTC derivatives transactions involve sophisticated counterparties, and, unlike the futures markets, there is virtually no "retail" market for these transactions.

The use of OTC derivatives is a positive force in the financial markets. As Federal Reserve Chairman Greenspan noted at a recent Senate Banking Committee hearing (March 7, 2002) "they (derivatives) are a major contributor to the flexibility and resiliency of our financial system. Because remember what derivatives do. They shift risk from those who are undesirous or incapable of absorbing it to those who are." OTC derivatives are used to unbundle risks and transfer those risks to parties that are able and willing to accept them. For example, if a corporation has floating rate debt outstanding and is concerned that interest rates might rise, it could use an interest rate swap to effectively convert its debt into a fixed rate obligation, thereby fixing its exposure. Similarly, if business has the right to receive non-dollar denominated revenues from a foreign-based affiliate, it could use a currency swap to hedge the risk of exposure to fluctuating exchange rates.

OTC derivatives transactions can be custom tailored to meet the unique needs of individual firms. Due to the tailored nature of such transactions and their bilateral nature, and other factors, OTC derivatives differ substantially from the standardized exchange-traded futures contracts regulated by the CFTC. In a typical OTC derivatives transaction, two counterparties enter into an agreement to exchange cash flows at periodic intervals during the term of the agreement. The cash flows are determined by applying a prearranged formula to the "notional" principal amount of the transaction. In most cases, such as interest rate swaps, this notional principal amount never changes hands and is merely used as a reference for calculating the cash flows. Almost any kind of OTC derivative can be created. The flexibility and benefits that these transactions provide have led to their dramatic growth. In addition to interest rate and currency transactions, commodity, equity, credit and other types of transactions are widely used. Transactions take place around the world, but the United States has been a leader in the development of OTC derivatives transactions, and American businesses were among the earliest to benefit from these risk management tools. The dramatic growth in the volume and diversity of OTC derivatives transactions is the best evidence of their importance to, and acceptance by, end users.

While its use is a matter of choice among the parties to the transaction, almost all OTC derivatives contracts both within and outside the United States are based on a Master Agreement published by ISDA. The ISDA Master Agreement is a standard form and governs the legal and credit relationship between counterparties, and incorporates counterparty risk mitigation practices such as netting and allows for collateralization. The ISDA Master Agreement also addresses issues related to bankruptcy and insolvency, such as netting, valuation and payment. The strength of the ISDA documentation and the important actions taken by Congress (and regulators) to ensure that OTC derivatives contracts would be enforceable in accordance with their terms have contributed positively to the ability of the financial and commodity markets to absorb events such as the Enron bankruptcy without systemic risk.

Legal Certainty and the CEA

The availability of OTC derivatives transactions within a strong legal framework is of vital importance. Any uncertainty with respect to the enforceability of OTC derivatives contracts obviously presents a significant source of risk to individual parties to those specific transactions. Moreover, any legal uncertainty creates risks for the financial markets as a whole and precludes the full realization of the powerful risk management benefits that OTC derivatives transactions provide. One of ISDA's principal goals since its inception has been to promote legal certainty for OTC derivatives transactions.

"Legal certainty" simply means that parties must be certain that the provisions of their OTC derivatives contracts will be enforceable in accordance with their terms. For example, ISDA has sought to establish (i) clarity concerning how OTC derivatives transactions will be treated under the laws and regulations of the United States as well as many other countries; (ii) certainty that OTC derivatives transactions will be legally enforceable in accordance with their terms and not subject to avoidance; and (iii) certainty that key provisions of OTC derivatives transactions (including netting and termination provisions) will be enforceable, even in the case of the bankruptcy of one of the parties. Within the United States, until the adoption of the CFMA, the CEA was the major source of legal uncertainty with respect to OTC derivatives. As discussed below, both Congress and the CFTC have since the late 1980s acted to provide increased legal certainty for OTC derivatives.

The original version of what is now the CEA was enacted in 1922 to ensure that participants in the commodities futures markets were not defrauded and that those markets, which served significant price discovery functions, were not manipulated. To achieve these objectives, the CEA required, and still requires, that all futures contracts on covered commodities be traded on a government-regulated futures exchange. Under this "exchange-trading requirement", all futures contracts that are not traded on a regulated futures exchange are illegal and unenforceable.

As originally enacted, the CEA applied only with respect to certain agricultural commodities. In 1974, the CEA was substantially revised by (i) establishing the CFTC as an independent agency to administer the CEA; (ii) expanding the definition of "commodity" to include (with certain exceptions) "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt with"; and (iii) at the request of the Treasury Department, providing a statutory exclusion from the CEA for transactions in or involving government securities, foreign currencies and certain other similar commodities.

1989 Swaps Policy Statement. In the late 1980s, the use of interest rate and currency swaps and other OTC derivatives transactions to manage financial risks grew rapidly. At this time, there was a consensus that OTC derivatives were not "futures" contracts. Nevertheless, because of certain perceived similarities between OTC derivatives and exchange traded futures contracts, there was residual concern that the CFTC or a court might treat OTC derivatives contracts as futures, which would render them illegal and unenforceable by reason of the CEA's exchange trading requirement.

To address these concerns, the CFTC issued a Swaps Policy Statement in 1989 stating its view ". . . . that at this time most swap transactions, although possessing elements of futures or options contracts, are not appropriately regulated as such under the

CEA. . . ." The CFTC also established a nonexclusive safe harbor for swaps transactions that met certain requirements (e.g., that they were undertaken in connection with a line of business and not marketed to the general public). The Swaps Policy Statement provided legal certainty that the CFTC would not initiate enforcement actions with respect to OTC derivatives that satisfied the safe harbor, but it did not and could not eliminate the risk that a counterparty to an OTC derivatives contract would attempt to avoid its contractual obligations by seeking a court ruling that the contract was an illegal off-exchange "futures" contract.

Futures Trading Practices Act of 1992 (FTPA). In 1992, Congress itself took a major step to provide legal certainty that the CEA was not applicable to OTC derivatives by passing the FTPA. In this important legislation Congress provided the CFTC with explicit statutory authority to issue exemptions from the CEA. The purpose of granting this exemptive authority was ". . . to give the [CFTC] a means of providing certainty and stability to existing and emerging markets so that financial innovation and market development can proceed in an effective and competitive manner."

In passing the FTPA, Congress specifically directed the CFTC to resolve legal certainty concerns with respect to OTC derivatives by promulgating an exemption for swaps and certain hybrid contracts. In order to avoid any implication that any class of OTC derivatives transactions were "futures," the Congress made it very clear that granting of an exemption does not ". . . require any determination beforehand that the agreement, instrument or transaction for which an exemption is sought is subject to the [CEA]."

1993 CFTC Exemptions. In response to the FTPA, the CFTC adopted a series of exemptions. In January 1993, the CFTC issued the Swaps Exemption and an exemption for hybrid instruments. The Swaps Exemption exempted certain types of OTC derivatives, when entered into between sophisticated counterparties, from most provisions of the CEA, including the exchange-trading requirement. In general, the Swaps Exemption covered a broader range of contracts than did the 1989 Swaps Policy Statement, but some types of OTC derivatives were not covered (e.g., other provisions of the CEA precluded application of the Swaps Exemption to OTC derivatives based on securities). In April 1993, the CFTC also issued an exemption for certain contracts involving specified energy products when entered into between commercial participants. This exemption, issued after notice and opportunity for public comment, was also intended to provide legal certainty that the covered energy contracts were not subject to regulation under the CEA.

1998 CFTC Concept Release and Congressional Moratorium. Despite these efforts by Congress and the CFTC to provide increased legal certainty that most OTC derivatives were not appropriately regulated as futures under the CEA, concerns continued to exist. These concerns proved to be neither academic nor speculative. In 1998, the CFTC issued a so-called "Concept Release" on OTC derivatives. As described by this Committee, the Concept Release

> ". . . was perceived by many as foreshadowing possible regulation of these instruments [OTC derivatives] as futures. The possibility of regulatory action had considerable ramifications, given the size and importance of the OTC market. This action [by the CFTC] significantly magnified the long-standing legal uncertainty surrounding these instruments, raising concerns in the OTC market, including suggestions it would cause portions of the market to move overseas.
> "This prospect led the Treasury, the Fed and the SEC to oppose the concept release and request that Congress enact a moratorium on the CFTC's ability to regulate these instruments until after the [President's] Working Group [on Financial Markets] could complete a stuffy of the issue. As a result, Congress passed a six-month moratorium on the CFTC's ability to regulate OTC derivatives." S. Rep. No. 103-390 (2000).

1999 President's Working Group Report. On November 15, 1999, the President's Working Group on Financial Markets issued its report entitled *Over-the-Counter Derivatives Markets and the Commodity Exchange Act.* The Report reflected an extraordinary consensus reached by the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission and the Chairman of the CFTC. It recommended that Congress enact legislation explicitly to clarify that most OTC derivatives transactions involving financial commodities generally are excluded from the CEA. As stated in the Report, " . . . an environment of legal certainty . . . will help reduce systemic risk in the financial markets and enhance the competitiveness of the U.S. financial sector". Indeed, as the

Report also noted, the failure to enact such legislation ". . . would perpetuate legal uncertainty and impose unnecessary regulatory burdens and constraints upon the development of these markets within the United States".

Commodity Futures Modernization Act of 2000 (CFMA). In December 2000, Congress passed the CFMA. This specific legislation was the product of more than two years of consideration. Four Committees of the Congress held hearings on and formally approved the legislation. At these hearings and elsewhere, key financial regulators (the Treasury, the Federal Reserve, the SEC and the CFTC) and other interested parties presented and debated the merits of various alternative proposals. At each stage of its consideration, bipartisan majorities approved the CFMA.

The principal purpose of the legislation was to eliminate, and not merely reduce, uncertainty with respect to the legal and regulatory status of most OTC derivatives transactions involving sophisticated counterparties. In this respect, as demonstrated by the preceding discussion, the CFMA did not mark a radical departure from prior policy. For more than a decade prior to passage of the CFMA, Congress am the CFTC had worked diligently and almost without exception to provide increased legal certainty that OTC derivatives transactions were not appropriately regulated as futures contracts under the CEA. The CFMA was therefore a culmination of a long and deliberate process to provide legal certainty for OTC derivatives and thereby reduce systemic risk and promote financial innovation.

III.

Experience Under the CFMA

Our experience to date under the CFMA indicates that Congress did indeed achieve its objective of providing legal certainty and regulatory clarity for OTC derivatives in a manner that would both reduce systemic risk and promote financial innovation. As noted above, the increased use of interest rate, foreign currency and credit derivatives has enabled American businesses and financial institutions to manage these key financial risks more effectively during the current economic downturn than would have otherwise been possible. In addition, the development of new types of OTC derivatives to manage other types of risks, as well as the emergence of clearing proposals, is evidence that the CFMA has created a climate that fosters financial innovation.

Equally significant, three events of the last two and one-half years have in many ways "stress tested" the OTC derivatives markets and the applicable provisions of the CFMA itself. The results have been encouraging. First, there is no question but that the CFMA structure has enabled firms to deal with the economic downturn in a more effective manner. The well publicized events leading to Enron's bankruptcy filing in December 2001 presented a second test. Enron raised serious concerns involving accounting practices, securities law disclosures and corporate governance policies. These issues received serious attention from policymakers and the Enron situation contributed to the decision of Congress to enact the Sarbanes-Oxley Act of 2002. Moreover, the CFTC and other regulators have conducted intensive investigations (some of which are ongoing) and have initiated a broad range of enforcement actions, including actions based on the CFMA.

Some have suggested, however, that Enron's OTC derivatives activities caused its demise. ISDA disagrees. In a detailed study entitled "Enron: Corporate Failure, Market Success", released in April 2002 (available on ISDA's web site), ISDA concluded that OTC derivatives did not cause, or contribute materially to, Enron's failure. Had Enron complied with accounting and disclosure requirements, it could not have built the "house of cards" that eventually led to its downfall. The market in the end exercised the ultimate sanction over Enron and the market for swaps and other OTC derivatives worked as expected and experienced no apparent disruption. The OTC derivative market did not fail to function in the Enron episode. Indeed, market participants have learned much about risk management in recent years. Considering the size of Enron, it is important to note that its failure did not have a systemic impact.

The equally well-publicized transactions of Enron and others in or with respect to the California energy market presented a third test involving different public policy questions; namely, the design of the California electricity market, the lack of adequate reserves, demand response relative to growing electricity demand and possible manipulation of the wholesale market. ISDA views any credible allegations of "manipulation" in financial or other markets as a serious matter requiring attention and therefore welcomed the investigations by the appropriate federal agencies and departments, including the CFTC, the Federal Energy Regulatory Commission (FERC) and the Department of Justice. Both FERC and the CFTC have now initiated a series of enforcement actions employing the tools available under existing law, including the CFMA.

On May 7, 2003, ISDA released a white paper entitle "Restoring Confidence in the U.S. Energy Trading Market" (available on ISDA's website). In addition to analyzing the events that led to the loss of confidence in these markets, the paper identified the regulatory framework (as enhanced by the CFMA) as one of the factors that was effective in countering the fallout from market events. As in the case of the Enron bankruptcy, the CFMA contributed to the ability of the markets to respond to a difficult situation with potentially broad ranging impact.

IV.

Conclusion

OTC derivatives are a major contributor to the flexibility and resiliency of our financial system. They allow businesses, financial institutions, governmental entities and other end users to manage the financial, commodity, credit and other risks inherent in their core economic activities in an efficient manner. The CFMA provide legal certainty and regulatory clarity for OTC derivatives in a manner consistent with the long-standing policies of Congress and the CFTC that OTC derivatives are not appropriately regulated under the CEA as futures contracts. This policy, now codified in the CFMA, materially reduces systemic risk and encourages financial innovation. The recent economic downturn, and the manner in which the OTC derivatives markets functioned in the case of the collapse of Enron and the California energy market situation, have, together with the enforcement actions of the CFTC under the CFMA, confirmed that the policy judgments Congress made in 2000 were sound then and remain so today.

TESTIMONY OF DANIEL J. ROTH
PRESIDENT AND CHIEF EXECUTIVE OFFICER
NATIONAL FUTURES ASSOCIATION

BEFORE THE SUBCOMMITTEE ON GENERAL FARM COMMODITIES AND RISK MANAGEMENT
OF THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON AGRICULTURE

JUNE 19, 2003

My name is Daniel Roth, and I am President of National Futures Association. NFA appreciates the opportunity to appear here today to present our views on some of the issues arising under the Commodity Futures Modernization Act of 2000 ("CFMA").

As the industrywide self-regulatory organization, NFA occupies a unique position in the futures industry. Like the exchanges, we are a self-regulatory body, but, unlike the exchanges NFA does not operate a marketplace. Self-regulation is not part of what we do—it is all that we do. Like the trade associations, we are a membership organization, but, unlike those associations, we are not a lobbying organization. We are first, foremost and only a regulatory body devoted to customer protection.

Our 4,000 Members include futures commission merchants ("FCMs"), introducing brokers ("IBs"), commodity pool operators ("CPOs") and commodity trading advisors ("CTAs"). We also regulate the activities of approximately 50,000 registered account executives who work for those Members. Our mission is to work as a partner with the CFTC to provide the industry with regulation that is both as effective and as efficient as possible. We think that this partnership has been an extraordinary success. In the twenty-one years since NFA began operation, trading volume on U.S. futures exchanges has increased by over 400%. During that same time, customer complaints have actually dropped by over 70%.

We all know, though, that a successful past does not ensure a successful future. The need for regulation that is both effective and efficient has never been greater. Effective regulation is the best way to assure public confidence, and we have all seen what happens to markets that lose the public's confidence. The best way to preserve that confidence is to deserve it—to ensure that the highest levels of integrity are demanded of all market participants and intermediaries. At the same time, the world becomes a more competitive place every day. The race belongs to those who can deliver the best products at the lowest price, and barriers and inefficiencies, including those regulatory in nature, simply cannot be tolerated.

I believe that the passage of the CFMA helped the industry and the regulators ensure effective and efficient regulation, but all of our problems have not gone away. I would like to tell you about some of the challenges NFA is facing now, the problems we are trying to solve by working with the CFTC and the industry. I would also like to bring you up to date on how NFA has performed the tasks assigned to us in the CFMA regarding single-stock futures.

CFTC IMPLEMENTATION OF THE CFMA

Before I turn to those issues, though, I want to make a point of commending the CFTC, in general, and Chairman Newsome in particular, for their leadership in implementing the CFMA. The Commission and its staff have worked hard to reduce unnecessary and costly regulatory burdens without reducing customer protection. They have done that by embracing the core principle regulatory philosophy adopted in the CFMA. The CFMA required the Commission to review the Act and the Commission's rules to ensure that regulatory requirements for intermediaries are flexible enough to address the industry's constant and rapid innovation.

The CFTC has done just that. For example, the Commission:

- Expanded the range of instruments in which FCMs and clearing organizations may invest customer funds;
- Replaced its detailed ethics training rule with a general standard;
- Provided customers and account controllers with greater choice in how they close out offsetting positions;
- Expanded FCMs' ability to hold customer funds in other currencies and in foreign depositories;
- Provided temporary relief and proposed permanent relief from CPO and CTA registration where certain conditions are met;
- Proposed rules to extend the pricing advantages of bunched orders to retail customers; and
- Proposed changing how CTAs calculate performance so that customers receive more accurate information.

Efficient regulation is not just a question of how you write the rules—it also involves making the best use of regulatory resources. For the last twenty years the CFTC has delegated certain of its frontline regulatory responsibilities to NFA to avoid duplication of effort and to direct its own resources where they are most needed. That trend has continued and accelerated since the passage of the CFMA. Let me give you just a few examples.

- In early January, the Commission delegated to NFA the authority to review the annual financial reports that commodity pool operators are required to provide to the CFTC and to their customers. This delegation eliminated the burden of filing those reports with both the CFTC and NFA. At the same time, NFA collaborated with the CFTC to implement technology that allows CFTC staff to electronically access and query information NFA maintains relating to pools in our databases. During the last six months, NFA's compliance staff has analyzed over 2,100 pool financial statements filed by CPOs with NFA.

- In mid-March, the CFTC authorized NFA to review the prospectus-type disclosure document that CPOs provide to customers for publicly-offered commodity pools. In 1997, the CFTC delegated this responsibility to NFA for disclosure documents for privately offered pools of CPOs and managed account programs offered by CTAs. NFA's team of specialists review about 200 disclosure documents each month. Our turnaround time averages a few days. We still have not eliminated all duplication of effort, however, since public pool documents are still reviewed by both NFA and the SEC. We hope that we can eliminate this duplication in the future.

NFA believes that we can also eliminate duplication of effort in the area of dispute resolution, but that would require congressional action. As we have testified before, we believe that the CFTC's reparations program has outlived its usefulness. When NFA began operations, the CFTC received almost 1,000 cases a year from retail customers — the reparations program was a valuable forum for those customers. Last year the Commission processed just 80 cases while 136 cases were filed with NFA's arbitration program. That's good news — it means that the combined enforcement efforts of NFA and the CFTC have had a real impact and that the public has great confidence in NFA's program. It also means that Congress should eliminate the requirement that the CFTC be the only federal financial regulator that operates a dispute resolution program.

In addition to the formal delegations I just mentioned, NFA constantly works informally with the CFTC. For example, during the last two months, NFA has assigned three of our staff to work full-time with the CFTC on investigations relating to energy and off-exchange foreign currency transactions. We value our partnership with the CFTC and will always strive to find new ways to work together to provide effective and efficient regulation.

RETAIL FOREX TRANSACTIONS

As I mentioned, the passage of the CFMA has not solved all of our problems. There are a number of important customer protection issues facing us today. I would like to explain those issues and what steps we are taking to address them.

The first area relates to off-exchange foreign currency transactions with retail customers. In passing the CFMA, Congress attempted to clear up confusion involving the Treasury Amendment and the CFTC's jurisdiction over off-exchange forex contracts sold to retail customers. Simply stated, the Congress intended to provide that "otherwise regulated entities," such as FCMs, broker-dealers and insurance companies, could sell forex contracts to retail customers outside of the Commodity Exchange Act. Unfortunately, the actual wording of the statute may have closed one loophole and opened another.

The CFMA provides that if an otherwise regulated entity is a "counter party" to the retail forex trade, the regulatory provisions of the Commodity Exchange Act do not apply. That language leaves open the possibility that the counter party to the trade could be an FCM, but the person actually working the phones selling the product can be completely unregulated. That is just what has happened. As a result, hundreds of unregistered and unregulated entities—that do not act as counterparties—are currently soliciting retail forex customers. In fact, NFA has received information that several individuals that we charged with fraud in the futures industry are linked to these soliciting firms.

A second problem involves "otherwise regulated entities" that are not really otherwise regulated. Let me explain. A number of firms that have never done any futures trades and never intend to do any futures trades have recently registered as FCMs and become NFA Members. They have done this for the sole purpose of qualifying as "otherwise regulated entities" so they can do retail forex trades outside of the Commodity Exchange Act. From NFA's perspective, these firms are not really otherwise regulated because all of our rules apply to exchange-traded futures and options transactions and do not generally apply to off-exchange forex transactions.

To address these problems, we created a special Forex Dealer membership category for firms that register as FCMs so they can act as a counterparty to retail forex transactions. NFA currently has fourteen active Forex Dealer Members and ten more registered or pending firms that have indicated they intend to become Forex Dealer Members. In the aggregate, Forex Dealer Members hold approximately $170 million in retail customer funds, with the minimum retail account size ranging from $500 to $10,000. In the last eighteen months, we have reviewed approximately one hundred customer complaints relating to these firms' forex activities. NFA has also taken three emergency actions against Members for forex activities within the last twenty months. Due to the disproportionate number of complaints we have received relating to these transactions, forex clearly has demanded a lot of our regulatory resources during the last year.

Since the applicability of our compliance rules is limited to exchange transactions, NFA's Board adopted and the CFTC approved an anti-fraud rule to cover the activities of these firms. Additionally, NFA's Board recently adopted several additional rules designed to protect retail forex customers against unethical business practices and loss of funds due to insolvency or related problems, and we will put them into effect once they are approved by the CFTC.

Our rules should help with both of our problems. First, the firms themselves will be subject to the type of regulatory oversight that Congress intended. These rules require Forex Dealer Members to:

- observe high standards of commercial honor and just and equitable principles of trade in connection with their retail forex business;
- supervise their employees and agents and any affiliates that act as counterparties to retail forex transactions;
- maintain minimum net capital based on the notional value of the open positions they carry for retail customers; and
- collect security deposits from those customers.

Second, with respect to the unregistered and unregulated persons soliciting retail customers for forex trades, one of the key provisions in NFA's pending rules gives NFA authority to discipline Forex Dealer Members for the activities of unregulated entities who introduce accounts to them or manage accounts for their customers.

We hope our proposed rules will help close any loopholes that may have been created. NFA will, of course, continue to carefully monitor its Forex Dealer Members' activities and the complaints filed against these firms. If at some point we determine that our rules are not effective and that congressional action may be called for, we will certainly communicate those concerns both to the CFTC and to Congress.

CUSTOMER RESTITUTION

A second problem that NFA and the CFTC have tackled relates to how best to return money to victims of fraud. Obviously, it is better to prevent fraud than to prosecute it, and the drop in customer complaints that I mentioned earlier shows that the CFTC and NFA have had success in those efforts. But even the best prevention efforts fail at times and some customers will be victims of fraud. I note that a subcommittee of the House Financial Services Committee is considering a bill with two basic purposes—to strengthen the SEC's enforcement powers and increase its ability to return funds to defrauded investors. Obviously, those goals are important to all of us, and I wanted you to know what the CFTC and NFA have already done to address the problem.

Together the CFTC and NFA developed a creative solution to the problem of how best to return funds to fraud victims several years ago. Specifically, in many circumstances, NFA has acted as a restitution service for cases that involve commodity fraud. Most of these cases are ones settled by the CFTC against non-Members of NFA. NFA receives copies of the signed settlement order that outlines the specifics of the case and the amount of restitution to be paid. These non-Members are ordered to pay a percentage of their income each year to the customers they have harmed. Our job is to make sure that the individual complies with the settlement's terms, which usually requires reviewing financial disclosure statements and tax returns. The individual submits a check made payable to the settlement account we set up and we then send a check drawn on that account to the defrauded investors.

To give you some idea of the scope of this service, we have opened bank accounts and administered funds for approximately 50 cases, with monies deposited in these cases ranging from as little as $1,000 to nearly $1 million. Since we began performing this restitution service fifteen years ago, NFA has paid out over $3 million to approximately 3,000 defrauded investors. We offer this service without charging any fees to the settlement account so that all the money possible is available for distribution to harmed investors. Frankly, in most cases the victims still receive only a small portion of their losses, but every cent paid into the restitution accounts goes to customers.

ANTI-MONEY LAUNDERING

One additional regulatory issue I wanted to address is anti-money laundering ("AML"). All of the financial regulators have adopted or are adopting all of the anti-money laundering rules required by the USA Patriot Act. The question now becomes how best to monitor all of the affected firms for compliance. As always, NFA's goal is make the most efficient use of the regulatory resources that are available.

The USA Patriot Act imposes significant new AML requirements on all financial institutions. In April 2002, NFA adopted requirements necessitating that FCMs and IBs have an AML program. NFA worked very closely with the Commission, U.S. Department of Treasury, and the industry in adopting these requirements. At the present time, NFA examines FCM and IB Member firms for compliance with these requirements and has worked with firms to ensure that they fully understand the elements of an effective AML program.

We also expect that Treasury in the near future will issue final AML rules for CTAs and unregistered investment companies, including commodity pools. At that time, we will adopt AML requirements for these Members and add steps to our audit programs to check for compliance with those rules. The fact is, though, that many of our CPO members operate other types of investment funds, either directly through our Member firm or though an affiliate of our Member firm. For example, 18 of the top 25 (55 of the top 100) hedge fund complexes are operated by NFA Member CPOs or their affiliates. Since we will already be auditing our Member firms for AML compliance, it only makes sense that we should examine their other funds and their affiliates for AML compliance as well. That's the only allocation of resources that makes sense, and we have informed the Treasury Department that we would be willing to take on that additional responsibility.

I should also note that the dramatic growth of the managed funds industry has, for the most part, been problem-free. CPOs and CTAs make up 60% of our membership but account for only 2% of customer complaints. We will continue to work closely with the CFTC to ensure that trend continues.

SECURITY FUTURES PRODUCTS

The CFMA not only emphasized the elimination of regulatory inefficiencies but also product barriers. With passage of the CFMA, Congress removed a barrier that prevented security futures products from trading for the last twenty years. The Act specified a very important role for NFA with respect to these products by designating NFA as a limited purpose national securities association. Before these products could begin trading, the CFMA specified that NFA had to have customer protection, suitability and sales practice rules for security futures that are comparable to National Association of Securities Dealers' ("NASD") rules.

NFA worked cooperatively with both the CFTC and the SEC, as well as the industry, and met all requirements well before security futures were ready to trade. Among other things, NFA implemented rules and interpretive notices that: (1) apply NASD's options suitability and promotional material requirements to security futures; (2) require Members to comply with relevant provisions of the Securities and Exchange Act of 1934, including the insider trading prohibitions; (3) require firms to have one or more designated security futures principals and adopt additional supervisory procedures for security futures products; and (4) impose best execution and fair commission requirements on firms.

In addition to adopting these rules, NFA also assumed responsibilities for processing the notice-registration forms for both the SEC and the CFTC, meaning that we now process some securities registrations as well as all futures registrations. We also worked cooperatively with NASD and other self-regulatory organizations to draft a separate risk disclosure statement for security futures products and developed a web-based training program – in partnership with NASD and the Institute for Financial Markets – that qualifies futures and securities registrants to offer security futures. While all three partners collaborated on the content, NFA developed the software and persuaded NASD that the training should be offered without charge.

NFA's responsibilities relating to these products did not stop the day they began trading six months ago. Since then, NFA has educated firms about the regulatory requirements for trading these products and closely monitors the sales practice activities of those firms that offer these products. At this time, we have received no customer complaints regarding these products.

SRO CONFLICTS OF INTEREST

Nobody in this room is a larger proponent of self-regulation than I am. Over the last twenty years NFA has shown how effective self-regulation can be in providing regulation that is both effective and efficient. At the same time, no one in this room would deny that there are certain conflicts of interest inherent in the concept of self-regulation. The CFTC's successful management of those conflicts has been one of its most important achievements over the years. Now, though, the industry is going through a period of dramatic change. As exchanges demutualize and become for-profit, and as the roles of intermediaries are changing, the nature of the conflicts of interest in the self-regulatory process need to be reexamined. To that end, we welcome Chairman Newsome's recent statement that the Commission will be examining whether changes to the market could affect the self-regulatory process. Obviously, the self-regulatory process has served this industry very well, but the Commission's inquiry is an appropriate one and NFA will cooperate in any way we can.

CONCLUSION

NFA's mission today is the same as it was twenty-one years ago. Everything we do is designed to protect customers, protect market integrity and protect the public's confidence in these vital markets. We are proud of what we have accomplished with the CFTC, but we recognize that challenges lie ahead. The industry we regulate is changing rapidly and dramatically and both the CFTC and NFA will have to respond to those changes. We are confident that we can and will work closely with Congress and the Commission to do so.

ckm/house ag testimony 6-19-03

Mr. Chairman, my name is Neal Wolkoff. I am the Executive Vice President and Chief Operating Officer of the New York Mercantile Exchange, Inc. ("NYMEX" or the "Exchange"), which is the world's largest forum for the trading and clearing of physical-commodity based futures contracts, including energy and metals products. NYMEX is a federally chartered marketplace, fully regulated by the Commodity Futures Trading Commission ("CFTC" or the "Commission"). On behalf of the Exchange, its Board of Directors and members, I want to thank you and all the members of the subcommittee for the opportunity to participate in today's hearing. The subcommittee's invitation stated that the purpose of today's hearing was to consider testimony concerning the Commodity Futures Modernization Act of 2000 ("CFMA"). Congress displayed bold leadership with the CFMA, which was a landmark piece of legislation that revised the Commodity Exchange Act ("CEA") in the most significant revisions of the last quarter-century.

The Exchange's comments and observations today will focus on our experiences as an entity that is regulated under two CFMA regulatory categories. We will also consider how the post-CFMA regulatory scheme has held up in the face of major developments in energy markets in the last two years. Among other things, we will analyze possible responses to the issue of faulty data submitted to price reporting and indexing services. While going somewhat beyond the focus of the CFMA, we also would like to address briefly the interplay between state and federal regulation of physical energy markets. Finally, we will close by considering whether it is premature at this juncture for Congress to undertake any whole-scale revisions of the CEA

NYMEX's Operation as a Designated Contract Market and as a Derivatives Clearing Organization

When the CFMA was passed by Congress in late 2000, NYMEX had been an exchange for nearly 130 years and had grown to become the world's largest exchange for futures trading based upon energy and precious metals

When the CFMA was enacted in December 2000, it amended the CEA by creating a number of alternative regulatory tiers applicable to trading facilities to replace the prior "one size fits all" regulatory approach. In general, the various regulatory tiers reflect different levels of regulation based upon the types of products to be offered by the trading facility and the participants who would be eligible to trade on the facility. In addition, Congress created a new statutory category of derivatives clearing organization ("DCO") and also codified a set of regulations specifically applicable to DCOs. The separation of the regulation of trading facilities from the regulation of DCOs confirmed that DCOs could operate as part of a trading facility or operate independently as a stand-alone entity.

With respect to these regulatory tiers for trading facilities, Congress grandfathered existing futures exchanges by allowing them to be designated in the contract market regulatory tier, the highest level of regulation, without needing to undergo a lengthy application process. Congress followed the same approach in grandfathering existing clearing organizations as DCOs.

Consequently, when the CFMA first went into effect, NYMEX continued its business operations by offering open outcry and electronic trading forums pursuant to the contract market regulatory tier. The Exchange continues to run our businesses in that same regulatory tier today.

We do so for a number of reasons. The overwhelming majority of our market users are commercial or other institutional companies seeking to use the Exchange's markets to meet their price discovery or hedging needs in energy and metals products. Notwithstanding their status as sophisticated, knowledgeable commercial entities, most of our market participants have expressed a strong desire to conduct their business in a fully and well regulated marketplace where the rules are applied consistently and assertively, and prices are transparent. The upheavals in the energy sector following the collapse of Enron have served as a reminder of the importance of market transparency and sensible regulation. Within the CFMA's highest regulatory tier, where we operate, the legislation has effected a return to regulation for the purpose of market integrity, while removing layers of prescriptive rules which failed a reasonableness test when viewed in the context of costs and benefits. Prior to the CFMA, regulation exacerbated an uneven playing field between domestic and international markets operating in this country, and imposed competitive constraints on Exchanges because of prior approval requirements for rule and contract changes even where few, if any, substantive regulatory concerns were present.

The Exchange recognizes that the transparency of NYMEX prices, and the integrity of our markets, make NYMEX a visible and reliable benchmark for energy pricing that is vital to our economy. Consequently, we believe that as a public market the contract market level of regulation is appropriate for the Exchange's established contracts, where NYMEX provides a broad public benefit. The visible and highly competitive daily transactions of energy futures and options on the Exchange provide a true world reference price for the commodities traded. In addition, although NYMEX is a marketplace for commercial participants in the energy realm to hedge risk and discover prices on large volume transactions, the benefits of this marketplace accrue to the consumers of energy who receive prices based on open and fair competition.

Within the Designated Contract Market ("DCM"), or highest, tier of CFMA regulation, the Exchange has benefited from the ability to effectuate operating rules without lengthy written submissions, and to introduce market oriented changes to contracts without undue processes for approval. Probably the most important observation to make about the contract market regulatory tier concerns the CFMA's replacement of very detailed prescriptive regulations with principles-based regulation, i.e., core principles. Congress in its wisdom made clear in the CFMA that regulated entities shall have reasonable discretion with respect to the manner in which they will comply with the core principles.

The CFTC has embraced the substance of the legislative changes that eliminated burdensome procedures in favor of common sense review, and shown an orientation toward protecting market integrity without the trappings of excessive paperwork. NYMEX has thrived in this new CFMA environment, and thanks Congress and the CFTC for its very positive steps to make the domestic regulated futures industry more robust and competitive than it has ever been. As a result of the change in regulatory approach under the CFMA, we have found that the Exchange now has substantially greater flexibility with respect to how we comply with regulatory standards than was true in the pre-CFMA environment, even though the contract market tier involves the highest level of regulation

The Exchange especially appreciates having the ability to submit new products and rules to the CFTC on a self-certification basis, and then make those changes effective on the next business day. Streamlining the product submission process has benefited our market users greatly by allowing NYMEX to bring new products to market much more expeditiously. Accordingly, the Exchange commends Congress on providing NYMEX and the other regulated markets with this new level of flexibility in the CFMA concerning how we operate our business lines on a day-to-day basis.

It is also our sense that use of a principles-based approach regulation is a more pragmatic and effective means for regulatory agencies to monitor effectively rapidly changing industries and markets. In other words, use of the core principles approach provides flexibility to regulators as well as to regulated entities.

In addition to operating as a DCM, NYMEX also provides clearing services as a registered Designated Clearing Organization or DCO. Like the DCM, the CFTC fully regulates the DCO's conduct and rule set. As a brief bit of background, NYMEX's clearinghouse provides the processing functions to assure the correct assignment of trades, but most importantly the clearinghouse provides a financial guaranty for all transactions executed on the Exchange, and also for those transactions executed off-Exchange but accepted by a NYMEX clearing member firm for clearing through the clearinghouse. The clearing function protects market participants against counterparty credit risk, which is simply the risk of failure of either one of the two parties to a transaction (the buyer or the seller) to pay such funds as they become due to his or her counterpart as a result of the trade. At NYMEX, the clearinghouse is operated as another division or department of the Exchange. Through a system of cross guarantees among the brokerage firms and banks that comprise NYMEX's clearinghouse, credit risk is mitigated for each participant, because financial performance is generally guaranteed by the Exchange and backed by its clearing members (although market users maintain a limited credit exposure to the futures commission merchant carrying their account). Customer funds are held by the Exchange and its clearing members in trust accounts, which are segregated from the exposure and funds of the clearing firm or the Exchange itself.

The core principles for DCOs included in the CFMA largely codified the prudent and reasonable standards that the CFTC had informally applied to clearing organizations in prior years; thus, the current application of these core principles to NYMEX in its status as a DCO has not noticeably affected the Exchange's day-to-day clearing operations. NYMEX recognizes that the ongoing operation of a clearinghouse necessarily entails some concentration of financial risk. Accordingly, the Exchange is continually reexamining its operations and procedures to develop the strongest possible financial oversight and surveillance systems.

NYMEX has also taken a number of steps in recent years to further enhance the financial strength and integrity of the clearinghouse. Just last month, NYMEX consolidated into one fund the two guaranty funds that had been maintained separately (as one of several sources of financial backing) for transactions on the NYMEX Division and the COMEX (metals) Division. As a result of this consolidation, the NYMEX guaranty fund has roughly doubled to its current size of approximately $128 million. As part of this change, the Exchange also increased the amount that could be assessed from Clearing Members in the event that the Guaranty Fund would be exhausted. Another major enhancement to the Exchange's clearinghouse that occurred last month was the addition of $100 million in default insurance that is also now available as a source of financial backing. The Exchange has also raised minimum working capital requirements for NYMEX Clearing Members to $5 million, although most clearing member firms handling public customer business have far more capital than the minimum.

NYMEX specializes in understanding the peculiar risks associated with metals and energy, and our internal risk management procedures involve strict oversight to regularly evaluate risk, and to treat the financial integrity of the marketplace as a much higher business priority than building trading volume. Margins are established to collateralize fully the risk of a position without regard to the impact such costs might have on trading participation. A host of safeguards, layer upon layer, are imposed by the Exchange, and overseen daily by the CFTC, to carry out our responsibilities.

The Exchange was pleased to obtain recently a AA+ credit rating from Standard & Poors, largely in recognition of our regulatory procedures and thoroughness in our market oversight. In other words, we view the issuance of this credit rating as tacit recognition of the experience and expertise that NYMEX has developed over the years in energy and metals risk management.

While some might question whether the shift by a few regulated markets to a for-profit status could hypothetically affect the extent of a regulated entity's self-regulatory efforts, the Exchange's experience would indicate that shifting to a for-profit status instead elevates the importance of effectively addressing reputational risk. This is particularly the case for institutions where a level of regulation has come to be associated with the institutional brand. NYMEX's status as a de-mutualized for-profit company has only heightened the transparency with which the Exchange operates. NYMEX files regular reports with the SEC, and has a duty to disclose publicly any material adverse information. Any event that NYMEX allows to call into question its commitment to excellence of its market management will be known and widely disseminated, to the detriment of its members, who are also shareholders (NYMEX does not have public shareholders).

Post-CFMA Energy Market Developments

There have been quite a series of challenging situations in energy markets in the last several years, and some observers have suggested that these events may have implications for the CFMA . A partial list of such challenges might include electricity price spikes in various markets, the financial meltdown of Enron and the resultant impact of that crisis on the energy merchant sector, the waves of disclosures regarding so-called "round-trip" or "wash trades" executed on less regulated markets, the additional disclosures regarding inaccurate reporting of price data to various price reporting services, and the periodic volatility in specific markets, such as the run-up in oil prices prior to the war with Iraq.

NYMEX's various regulatory safeguards allowed the Exchange to maintain solid footing during these very challenging periods. The Enron meltdown may serve as an instructive example. In the early stages of Enron's difficulties in the fall of 2001, some observers feared that Enron's substantial position in the OTC marketplace could pose serious problems for a significant number of OTC market participants. However, Enron's counterparties realized the risk in being paired against a company in ever-worsening condition and made alternative arrangements, including transferring positions to the NYMEX.

During that same period, NYMEX market surveillance functions, using established tools such as large trader reporting, position limits, and position reporting, alerted staff to potential problems. To address issues arising from the Enron situation, the Exchange implemented a number of measures:

- Margin requirements (cash required as a guarantee of fulfillment of a futures contract) on natural gas contracts were increased.
- Approval was sought from, and granted by, the CFTC for the use of EFS ("Exchange of Futures for Swaps") instruments for natural gas to allow market participants to migrate their positions from the OTC marketplace to NYMEX.
- NYMEX implemented policies to reduce exposure to Enron's credit risk by NYMEX traders.

Indeed, as the measures were enacted, the Exchange witnessed a remarkable "flight to quality," as market participants moved to the NYMEX where financial performance is largely guaranteed by the safety and soundness of a federally overseen clearinghouse.

Episodes like the Enron failure heighten the awareness that NYMEX is a relatively safe haven, and that the benefits to doing business on a regulated marketplace hold great appeal, or should, to any corporation with credit or price exposure to energy. We believe that corporate boards and treasury offices should become more involved as a matter of their fiduciary obligations to their employees and shareholders to learn about the differences between regulated and unregulated marketplaces.

Chief among the lessons to be taken from the Enron bankruptcy is the value provided by the federally chartered, regulated commodity marketplace in supplying market oversight and credit enhancement. The ability of market participants to move from largely unregulated trading platforms to the Exchange, where transparency, liquidity, and market oversight are the watchwords, proved to be of critical value in avoiding broad ranging disruptions as Enron's problems became known.

NYMEX Clearing Services for Transactions Executed Off-Exchange

NYMEX not only operated safely during this volatile period, but thanks to the flexibility permitted under the CFMA, NYMEX has been able to serve this battered market segment with necessary services to stabilize the many affected businesses, and avoid disruptive corporate or cash market meltdowns. By opening our clearing system – under the regulatory supervision of the CFTC – to transactions executed off-Exchange, NYMEX has been able to provide ongoing cash market liquidity, because participants who previously could not transact business with each other because of credit constraints could now do so.

The Enron meltdown set in motion a number of ripple effects throughout the energy merchant sectors for natural gas and power. The financial weakness of such a large market participant brought new focus and concern to the financial strength of other energy firms and to the issue of counterparty credit risk. In the post-Enron environment, a number of other energy trading companies who had amassed significant debt saw their credit ratings and stock prices tumble. As concerns regarding counterparty credit became more severe, a liquidity crisis began to develop in these markets. Energy firms clearly needed to find new mechanisms and solutions to mitigate these credit issues.

In response, NYMEX took advantage of the broader scope of clearing activity provided by the CFMA to DCOs and initiated a new clearing service in May 2002. The CFTC deserves tremendous credit in cooperating to allow this valuable new service to start, using its new authority for flexible regulation to approve a new and innovative service while taking prudent steps as a careful regulator to preserve a maximum of systemic integrity. This service allows cash market participants who have established a business relationship with a NYMEX Clearing Member to submit energy transactions in specified products to NYMEX for clearing. As part of this clearing process, the off-Exchange contracts would be extinguished and, in their stead, futures positions would be carried at the clearinghouse by their Clearing Members that would be thus subject to the same protections afforded to other futures contracts, such as daily marking to market.

The Exchange's clearing services have clearly responded to a real business need, and over the last year, our clearing services have achieved a reasonable level of acceptance and usage by the business community. We currently have over 200 companies registered to use this program, and we have now cleared more than 3 million contracts in this new program. The contracts cleared include a broad array of natural gas and natural gas basis contracts as well as a number of financially settled power contracts. We hope to continue to meet the needs of market users by gradually expanding the scope of this service over time.

Cash Market Energy Price Reporting and Price Indices

There is now a broad consensus among energy market users that there is a real crisis of confidence regarding the reliability of energy price indices and generally the validity of prices reported by cash market participants in certain energy commodities. For example, a March 2003 report issued by the Federal Energy Regulatory Commission's ("FERC") Western Markets Task Force concluded that employees of several energy firms had reported false price information to publishers of price indices. The CFTC has also taken enforcement actions in this area, for example, recently entering into one settlement with a major trading firm. That case involved allegations of attempted manipulation and false price reporting and the settlement included among other sanctions a $20 million fine. Similar CFTC enforcement actions may follow in the weeks and months ahead.

Enforcement actions aside, both regulators and energy market participants alike have begun to search for new procedures and market mechanisms to address the current crisis of confidence in energy price formation processes. The CFTC and FERC jointly sponsored a conference held in April on this subject, and FERC, the CFTC and the National Association of Regulatory Utility Commissioners will be sponsoring a follow-up conference, on June 24, 2003, on energy price formation and price indices for natural gas and electricity. One proposal that seems to be taking hold would entail firms acting as price validation services who would conduct external audits of energy prices submitted to energy price index providers. NYMEX has suggested that this type of function would be most amenable to a regulatory structure under which a regulatory agency such as the CFTC or FERC delegated oversight responsibilities to another entity (or group of entities). This approach, which is usually referred to as the self-regulatory organization or SRO approach, would result in the SRO or SROs being responsible for a number of duties in areas such as auditing, compliance, rulemaking, and standardization of formats.

The Exchange believes that the SRO model offers the prospect for a real world solution to the current problem, but this model need not entail excessive governmental regulation. In designing a SRO structure for this purpose, NYMEX generally favors a cost-conscious, pro-market approach. Thus, the Exchange would suggest that the SRO model should permit a number of qualified entities to be designated as an SRO to promote market competition in providing this service to energy markets.

Role of Federal and State Governments in the Regulation of Gasoline Markets

The Exchange would also like to include a few brief comments regarding another current energy industry topic: the requirements applicable to gasoline sold in the Northeastern region. To be clear, NYMEX as an institution is completely price neutral; on each business day, there is an equal number of contracts bought as well as sold on the Exchange, and we do not have a vested interest in the profits or losses of either side of the market to the detriment of the other side. NYMEX also does not take a position on the environmental impact of ethanol or MTBE, and we do not prefer or advocate the use of either additive to gasoline to fulfill the current federal requirements for oxygen standards in Reformulated Gasoline (RFG). NYMEX's concern is to see uniformity of grade and quality standards governing RFG specifications across the New York Harbor region which, as a marketplace, is one contiguous region despite distinctions in state borders.

At this point in time, New York State is set to implement a ban in New York on all gasoline with MTBE commencing on January 1, 2004. By comparison, New Jersey will permit its continued use. Meanwhile, Congress is considering a comprehensive energy bill which, if adopted, would end the oxygenation requirement for gasoline in this region sometime in 2004. In effect, MTBE would largely disappear from the scene, and ethanol would not be required in reformulated gasoline in the New York area. In other words, there is the prospect of intervening federal action prior to the January 1, 2004 start of the New York ban that would render New York's MTBE ban at the state level unnecessary. However, until Congress takes action, the industry needs to prepare for a scenario where one kind of gasoline is restricted in New York but otherwise available in New Jersey. Gearing up for this possibility of a two-tier type of regional market involves significant costs to our market users, planning and preparation costs that would become moot by Congressional action in this area.

Premature Revision of the Commodity Exchange Act

Over the last year or so, some have suggested that it would be useful to clarify the scope of the CFTC's anti-fraud and anti-manipulation over certain products and markets, and have further suggested a need for greater transparency and public accountability for certain markets within the CFTC's jurisdiction, particularly if such markets begin to serve a price discovery function. While NYMEX is generally supportive of these policy goals, we also take note of the extensive number of investigations now underway by the CFTC. Several of these investigations have resulted in complaints being filed and also settlements involving significant fines. When Chairman Newsome appeared before this subcommittee two weeks ago, he noted that there "may well be" additional complaints filed in the near future. Accordingly, we believe that the best public policy approach would be to defer Congressional consideration of amendments to the CEA until the CFTC has had an opportunity to complete its ongoing matters. At that time, a clearer picture should emerge as to whether there is a need to amend the CEA.

We are also appreciative of Chairman Newsome's concern that a general reopening of a major statute like the CFMA can result in unintended consequences, including mischief by special interests to dilute certain regulatory safeguards while others are being strengthened. At this time, the marketplace, including shareholder groups, and federal investigators, regulators and prosecutors have provided many of the benefits sought last year through an amendment of the statute. We believe the time is not at hand for another reopening effort.

In addition, by deferring consideration of possible CEA revisions until a more appropriate juncture, Congress would also be allowing exchanges and clearing organizations further opportunity to make business decisions on a voluntary basis as to how best to serve their customers, rather than having such decisions be made on the basis of regulatory directives. There is basis for believing that the ordinary operation of free markets may well bring about a number of benefits and services to market customers, such as use of portfolio margining for a broader array of products.

Once again, Mr. Chairman, thank you for the opportunity to participate in this important discussion.

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